

# COMPENSATION MANAGEMENT

**CHAPTER 2 (Study unit 2)**  
**Strategy: The Totality of Decisions**

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## Chapter Topics

- Similarities and Differences in Strategies
- Strategic Choices
- Support Business Strategy
- The Pay Model Guides Strategic Pay Decisions
- Developing a Total Compensation Strategy: Four Steps

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## Chapter Topics (cont.)

- Source of Competitive Advantage: Three Tests
- “Best Practices” versus “Best Fit”
- Guidance from the Evidence
- Virtuous and Vicious Circles
- Your Turn: Mapping Compensation Strategies
- Still Your Turn: Pay Matters (Productivity Does, Too)

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## Exhibit 2.1: Three Compensation Strategies

EXHIBIT 2.1 Three Compensation Strategies

	Google	Medtronic	Merrill Lynch
<b>Objectives</b>	Emphasis on innovation Commitment to cost containment Recognize contributions Attract and reward the best	Focus on customers Fully present at work and in personal lives Recognize personal accomplishment and share success Attract and engage top talent Control costs	Focus on customer Attract, motivate, and retain the best talent Fair, understandable policies and practices
<b>Internal Alignment</b>	Minimize hierarchy Everyone wears several hats Emphasize collaboration	Reflect job responsibilities Support promotional growth opportunities Foster team culture	Pay fairly within ML Job sized on four factors: knowledge/skill, complexity, business impact, strategic value
<b>Externally Competitive</b>	Explore novel ideas in benefits and compensation Generous, unique benefits	Market value of jobs establishes overall pay parameters Choices in benefits	Market competitive in base and benefits Market leader in bonus and stock
<b>Employee Contributions</b>	Recognize individual contributions Unrivaled stock programs	Incentives directly tied to business goals Opportunity to earn above-market pay Recognition of individual and team performance	Bonus based on individual, unit, and company success Differentiate on bonuses and stock In high-profit years, top bonuses significantly larger In less-profitable years, top performers' bonuses decrease much less than poorer performers
<b>Management</b>	Love employees, want them to know it Technology support	Clearly understood; open Technology support Employee choice	Understandable, consistent message Intranet support both individuals and managers

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## Learning Objectives

After studying Chapter 2, students should be able to:

- Explain the idea of a strategic perspective to compensation.
- Identify the five dimensions of a compensation strategy and how a compensation strategy can support an organization's strategy.
- Discuss how the pay model guides strategic pay decisions.
- Understand the four steps involved in developing a total compensation strategy.
- Discuss how three tests can be used to determine if a pay strategy can be a source of competitive advantage.
- Describe the key arguments related to the two approaches – best-fit vs. best-practices – in developing a compensation strategy and system.

## Similarities and Differences in Strategies

- Different strategies within the same industry
- Different strategies within the same company
- “Let the market decide our compensation” philosophy is untenable in the real world, especially in global environments

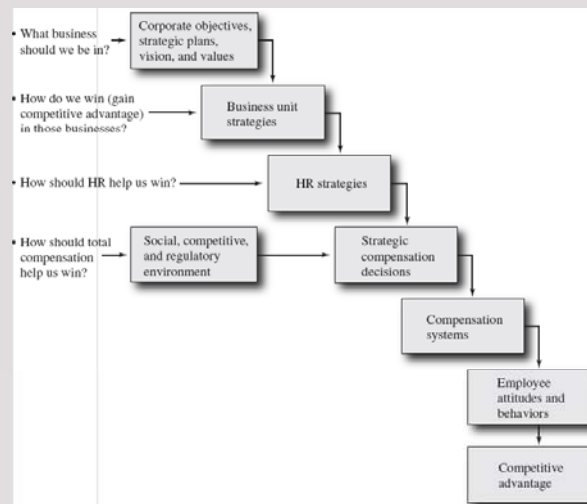
THUS:                    A strategic perspective on compensation is more complex than it first appears

## Strategic Choices

- *Strategy* refers to the fundamental directions that an organization chooses
  - Corporate level: “What business should we be in?”
  - Business unit level: “How to gain and sustain competitive advantage?”
  - Functional level: “How should total compensation help gain and sustain competitive advantage?”
  - A *strategic perspective* focuses on those compensation choices that help the organization gain and sustain competitive advantage

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## Exhibit 2.2: Strategic Choices



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## Support Business Strategy

- Pay systems should align with the organization's business strategy
  - Based on *contingency notions*: Differences in a company's business strategy should be supported by corresponding differences in its human resource strategy, including compensation
  - *Underlying premise*: the greater the alignment (fit) between the organisation and the compensation system, the more effective the organisation


## Support Business Strategy (cont)

- Compensation systems can be tailored to:
  - *Innovator* business strategy: stresses new products and short response time to markets
  - *Cost cutter* business strategy : efficiency focused strategy and stresses doing more with less by minimizing costs, encouraging productivity increases and specifying in greater detail exactly how jobs should be performed
  - *Customer-focused* business strategy: stresses delighting customers and bases employee pay on how well they do this

(Refer to Exhibit 2.3)

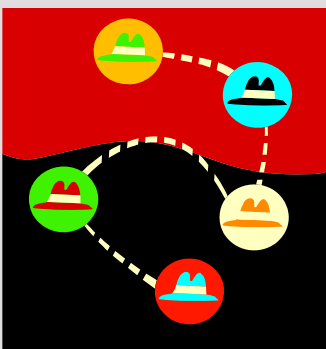
### Exhibit 2.3: Tailor the Compensation System to the Strategy


Strategy	Business Response	HR Program Alignment	Compensation Systems
<b>Innovator: Increase Product Complexity and Shorten Product Life Cycle</b>	<ul style="list-style-type: none"> <li>Product Leadership</li> <li>Shift to Mass Customization</li> <li>Cycle Time</li> </ul>	<ul style="list-style-type: none"> <li>Committed to Agile, Risk-Taking, Innovative People</li> </ul>	<ul style="list-style-type: none"> <li>Reward Innovation in Products and Processes</li> <li>Market-Based Pay</li> <li>Flexible—Generic Job Descriptions</li> </ul>
<b>Cost Cutter: Focus on Efficiency</b>	<ul style="list-style-type: none"> <li>Operational Excellence</li> <li>Pursue Cost-Effective Solutions</li> </ul>	<ul style="list-style-type: none"> <li>Do More with Less</li> </ul>	<ul style="list-style-type: none"> <li>Focus on Competitors' Labor Costs</li> <li>Increase Variable Pay</li> <li>Emphasize Productivity</li> <li>Focus on System Control and Work Specifications</li> </ul>
<b>Customer Focused: Increase Customer Expectations</b>	<ul style="list-style-type: none"> <li>Deliver Solutions to Customers</li> <li>Speed to Market</li> </ul>	<ul style="list-style-type: none"> <li>Delight Customer, Exceed Expectations</li> </ul>	<ul style="list-style-type: none"> <li>Customer Satisfaction Incentives</li> <li>Value of Job and Skills Based on Customer Contact</li> </ul>

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### Five Strategic Guidelines for Compensation Choices

- Objectives – how should compensation support the business strategy and be adaptive to the cultural and regulatory pressures in a global environment?
- Internal Alignment – How differently should the different types and levels of skills and work be paid within the organisation?
- External Competitiveness – how should total compensation be positioned against competitors?
- Employee Contributions: should pay increases be based on individual and/or team performance or experience and/or each business unit's performance?
- Management: How open and transparent should the pay decisions be to all employees?



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## The Pay Model Guides Strategic Pay Decisions

- Decisions based on the five strategic compensation choices of the pay model, taken together, form a pattern that becomes an organization's compensation strategy
  - Stated versus Unstated Strategies

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## Example: The Strategic Compensation Decisions Facing Whole Foods

- **Objectives:** How should compensation support business strategy and be adaptive to the cultural and regulatory global environment?

### Whole Foods' Objectives

- Increase shareholder value through profits and growth
- Go to extraordinary lengths to satisfy and delight customers
- Seek and engage employees who are going to help the company make money

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## Example: The Strategic Compensation Decisions Facing Whole Foods (cont.)

- **Internal Alignment:** How differently should the various types and levels of skills and work be paid within the organization?

### Whole Foods' Approach

- Store operations are organized around eight to ten self-managed teams
- Egalitarian, shared-fate philosophy – executive salaries do not exceed 14 times the average pay of full-time employees
- All full-time employees qualify for stock options, and 94 percent of the company's options go to non-executive employees

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## Example: The Strategic Compensation Decisions Facing Whole Foods (cont.)

- **External competitiveness:** How should total compensation be positioned against our competitors? What forms of compensation should we use?

### Whole Foods' Approach

- Offer a unique deal compared to competitors
- Provide health insurance for all full-time employees
- 20 hours of paid time a year to do volunteer work

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## Example: The Strategic Compensation Decisions Facing Whole Foods (cont.)

- *Employee contributions*: Should pay increases be based on individual and/or team performance, on experience and/or continuous learning, on improved skills, on changes in cost of living, on personal needs, and/or on each business unit's performance?

### Whole Foods' Approach

- A shared fate – every four weeks, assess the performance of each team
- Top teams get an extra R1.50 to R2.00 an hour in the next pay period

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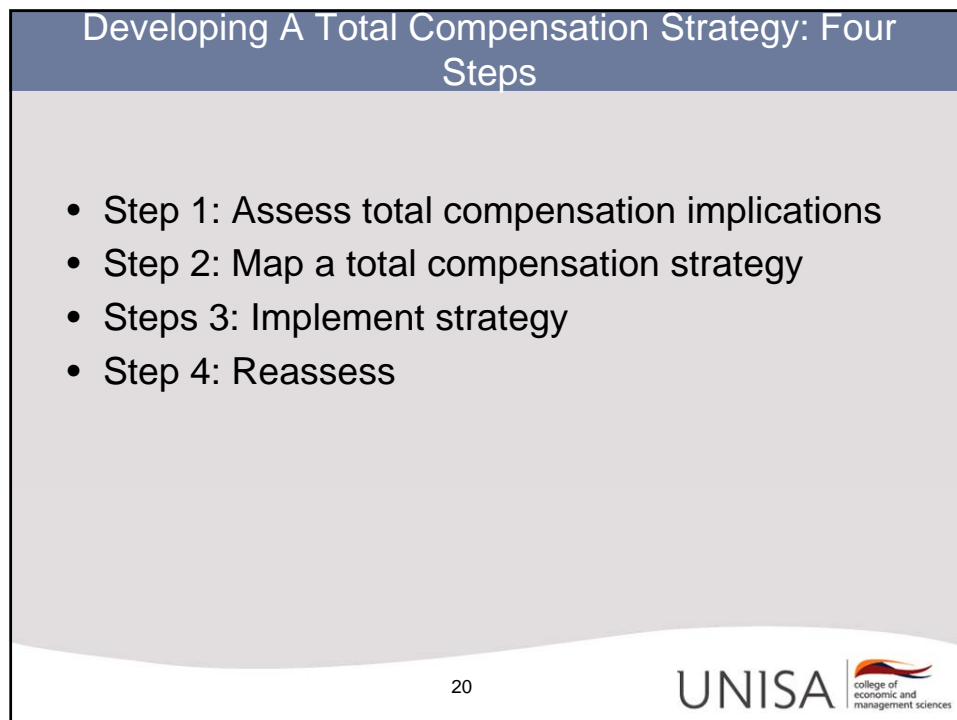
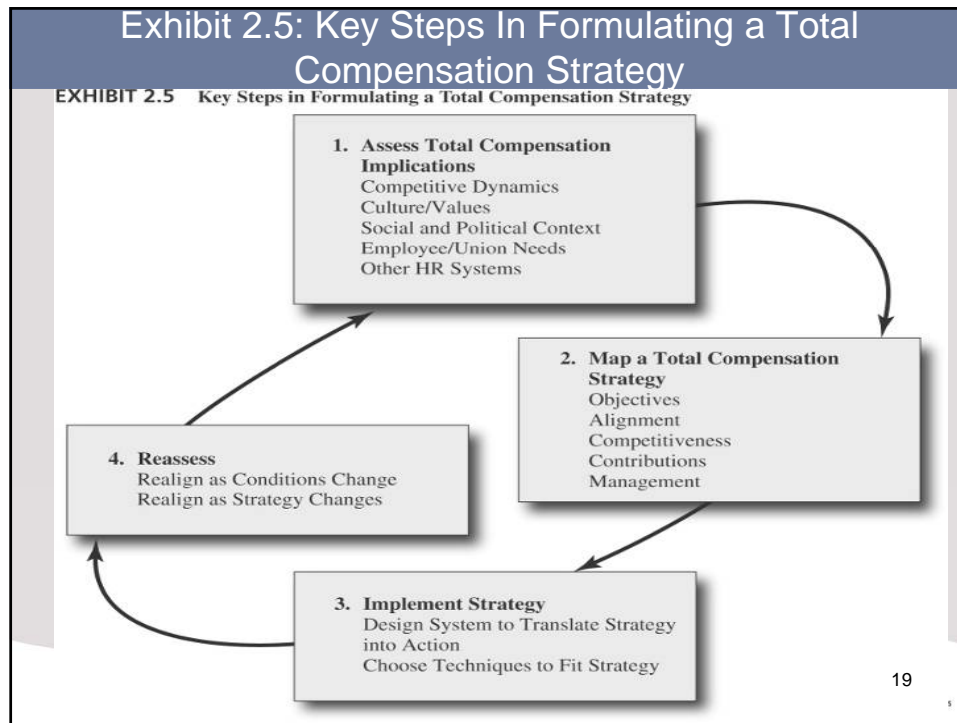
## Example: The Strategic Compensation Decisions Facing Whole Foods (cont.)

- *Management*: How open and transparent should pay decisions be to all employees? Who should be involved in designing and managing the system?

### Whole Foods' Approach

- “No-secrets” management; every store has a book listing the previous year's pay for every employee including executives
- “You Decide” – employees recently voted to pick their health insurance rather than having one imposed by leadership

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## Step 1: Assess Total Compensation Implications

- **Competitive Dynamics** – Understand the Business
  - To cope with turbulent competitive dynamics, focus on what factors are important in the business environment:
    - Changing customer needs
    - Competitors' actions
    - Changing labor market conditions
    - Changing Laws
    - Globalization
  - Competitive dynamics can be assessed globally
- **Culture/values**
  - A pay system reflects the values that guide an employer's behavior and underlie its treatment of employees
  - The pay system mirrors the company's image and reputation

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## Step 1: Assess Total Compensation Implications (cont.)

- **Social and political context**
  - *Context* refers to legal and regulatory requirements, cultural differences, changing workforce, demographics, expectations etc.
  - Affects compensation choices
  - Governments are major stakeholders in determining compensation: Lobbying to influence laws and regulations is also part of compensation strategies
  - From a strategic perspective: Managers of compensation may try to shape the sociopolitical environment as well as be shaped by it
- **Employee preferences**
  - How to better satisfy individual needs and preferences
  - Offering more choice is one approach

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## Step 1: Assess Total Compensation Implications (cont.)

- **Union preferences**
  - Pay strategies need to be adapted to the nature of the union-management relationship
  - Unions' interests can differ (i.e. protected retirement and health care plans)
  - Compensation deals with unions can be costly to change
- **Prominence of pay in overall HR strategy: Supporting player or catalyst for change**
  - Pay strategy is influenced by how it fits with other HR systems
  - High-performance systems
    - High skill/knowledge requirements
    - Work designed so that employee teams enjoy discretion in making decisions and continue to learn
    - Pay systems based on performance
  - Pay can be a supporting player or a catalyst for change

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## Step 2: Map a Total Compensation Strategy

- Mapping is used in marketing to clarify and communicate a product's identity
- Offers picture of a company's compensation strategy based on the five choices in the pay model
- Clarifies the message the company is trying to establish with its compensation system
- Maps do *not* tell which strategy is the "best", providing rather framework and guidance

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## Steps 3 and 4: Implement and Reassess

- Step 3
  - Involves implementing strategy through the design and execution of compensation system
- Step 4
  - Reassess and realign, closes the loop and recognizes that the strategy must be changing to fit changing conditions
  - Involves periodic reassessment

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## Sources of Competitive Advantage: Three Tests

- Three tests determine if a pay strategy is a source of advantage
  - Is it aligned?
  - Does it differentiate?
  - Does it add value?
    - Calculate the return on investment (ROI)



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## Best Practices” Versus “Best Fit”?

### **Best Practices**

- Assumptions
  - A set of best-pay practices exists
  - Practices can be applied universally across all situations
  - Results in better performance with almost any business strategy

### **Best Fit**

- If design of pay system
  - Reflects company's strategy and values
  - Is responsive to employees' and unions' needs
  - Is globally competitive
    - ❖ Company is more likely to achieve competitive advantage

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## Guidance from the Evidence

Consistent research evidence that the following practices do matter to the organization's objectives

- *Internal alignment*
  - ❖ Pay differences among internal jobs can affect results
- *External competitiveness*
  - ❖ Paying higher than average paid by competitors can affect results
- *Employee contributions*
  - ❖ Performance-based pay can affect results

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## Guidance from the Evidence (cont.)

- *Managing compensation*
  - ❖ Need to consider all dimensions of pay strategy
  - ❖ Therefore not focusing only on pay for performance or internal pay differences
- *Compensation strategy*
  - ❖ Embedding compensation strategy within the broader HR strategy affects results

“What practices pay off best under what conditions” is an important question to be answered

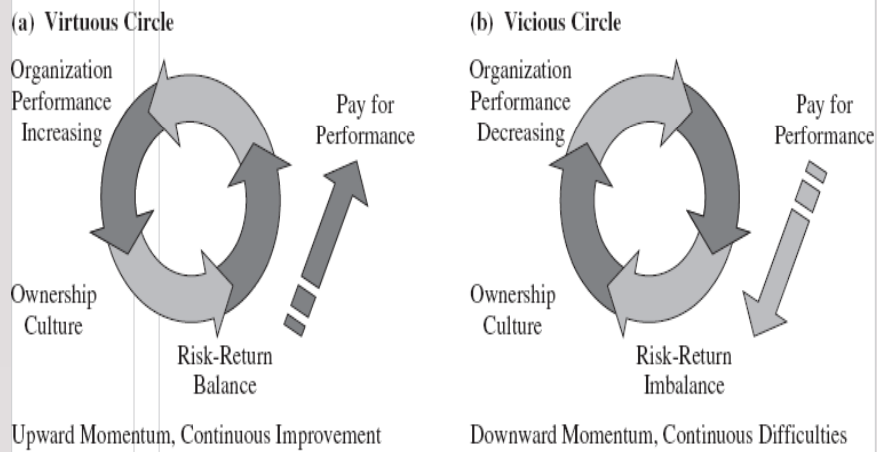
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## Virtuous and Vicious Circles

- One study concluded that *how* you pay also matters as much as *how much* you pay
- Studies conclude that performance-based pay that shares success with employees improves employee attitudes, behaviors, performance – especially when combined with high-performance practices
- Performance-based pay can be the best practice under right circumstances
- Think of pay as part of a circle (Refer to Exhibit 2.9 below)

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## Exhibit 2.9: Virtuous and Vicious Circles (cont.)



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## Virtuous and Vicious Circles (cont.)

- Exhibit 2.9 (a) suggest that performance-based pay work best when there is success to share
- An organisation whose profits or market share is increasing is able to pay larger bonuses and stock awards
- Paying these bonuses fairly improves employee attitudes and work behaviours, which in turn improves their performance
- The circle gains upward momentum. Employees receive returns that compensate for the risks they take.
- Employees behave like owners, since they are sharing in the organisation's success

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## Virtuous and Vicious Circles (cont.)

- Exhibit 2.9 (b) suggest that when organisation performance declines, performance-based pay plans do not pay off (there are no bonuses, and the value of their stock declines – with potentially negative effects on organisation performance)
- Declining organisation performance increases the risks facing employees – risk of still smaller bonuses, demotions, and even layoffs
- Unless the increased risks are offset by larger returns, the risk-return imbalance will reinforce declining employee attitudes and speed the downward spiral

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## Your turn

Answer the end of chapter 2 review questions

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