4BE3

Week 9

Pay for Performance Plans

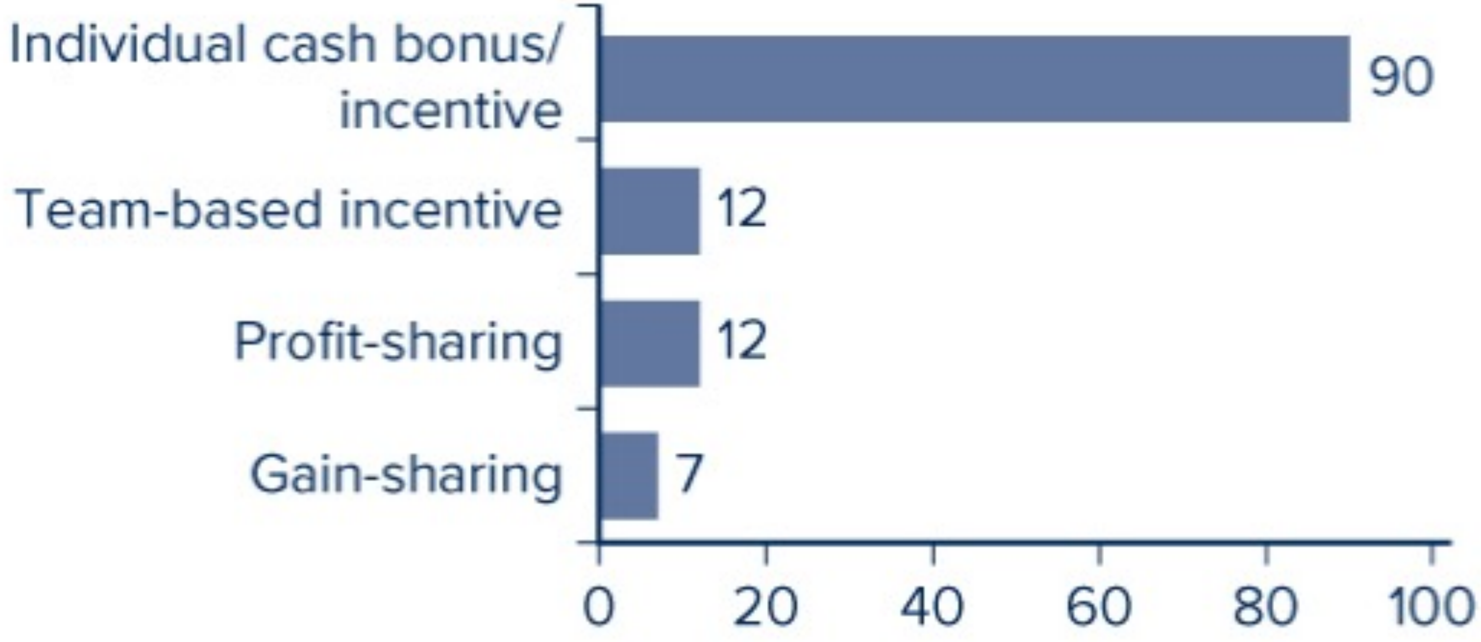
Learning Outcomes

- Describe three short-term, individual pay-for-performance plans.
- Describe three types of group incentive and discuss the five causes of problems with group compensation systems.
- Explain seven key issues in designing a gain-sharing plan.
- Explain the difference between stock options, broad-based option plans, and employee stock ownership plans.
- Identify the five basic elements of executive compensation packages.
- Define dual career ladders and maturity curves, and explain how these are used in compensating scientists and engineers in high-tech industries.

Pay-For-Performance Plans

- pay that varies with some measure of individual, team or organizational performance
- Signals a movement away from entitlement toward pay that varies with performance
- also called variable pay plans
- variable pay can be traced to two trends:
  - increasing competition from foreign producers, and
  - a fast-paced business environment requires workers adapt quickly to change.
- these plans can have a positive impact on performance if they are designed well

ariable Pay Plans in Canada



pers are percentages; based on organizations with at least one annual variable pay plan in pla
100 because some respondents have more than one plan.

Specific Pay-for-Performance Plans: Short Term

- Merit pay
- Lump-sum bonuses
- Individual spot awards
- Individual incentive plans

Merit Pay

- A merit pay system links increases in base pay to how highly employees are rated on a performance evaluation.
- Employee achievements are rewarded every year the employee remains on the job.
- Merit pay is expensive.
- Many argue it does not achieve the desired goal of improving employee and corporate performance.
- Merit pay does have a small, but significant, impact on performance.

Managing Merit Pay

- ❑ Improve accuracy of performance ratings
- ❑ Allocate enough money to truly reward performance
- ❑ Make sure size of merit increase differentiates across performance levels

Requirements to Link Pay to Performance

- Specify a continuum describing different levels from low to high on performance measure
- Decide how much of a merit increase is given for different levels of performance
- A more complex guideline ties pay not only to performance but also to position in the pay range

Lump Sum Bonuses

- Used as a substitute for merit pay.
- Based on performance and received as an end-of-year bonus. Not built into base pay.
- Viewed as less of an entitlement than merit pay.
- Less expensive than merit pay over the long run.

Individual Spot Awards

- Viewed as highly or moderately effective
- Usually awarded for exceptional performance.
- Larger companies use formal mechanisms while smaller companies may be more casual.

Individual Incentive Plans

- Offer a promise of pay for some objective, pre-established level of performance.
- All plans use an established standard for comparing worker performance to determine magnitude of the incentive pay.
- There are advantages and disadvantages.
- The most frequently implemented is a straight piecework system. Others include the Taylor plan and the Merrick system.

Group Incentive Plans

- A standard is established against which team performance is compared to determine the magnitude of the incentive pay.
- All team incentive plans can be described by common features:
  - The size of the group that participates in the plan.
  - The standard against which performance is compared.
  - The payout schedule.
- Performance measures can be: customer-focused, financially focused, capability focused, internal process focused
- There are advantages and disadvantages

Types of Group Incentive Plans

- Gain-Sharing Plans
  - employees share in cost-savings or productivity gains
  - Examples: Scanlon, Rucker, Improshare

- Profit Sharing Plans
  - variable pay plans requiring a corporate profit target to be met before any payouts occur

- Earnings-at-Risk Plans
  - incentive plans sharing profits in successful years and reducing base pay in unsuccessful years

Gain-Sharing Plan

Key elements of a gain-sharing plan:

- Strength of reinforcement
- Productivity standards – usually historical standards
- Sharing the gains
- Scope of the formula
- Perceived fairness of the formula
- Ease of administration
- Production variability

Gain-Sharing Plans

- Scanlon plans
  - Incentives are derived as a function of the ratio between labor costs and sales value of production (SVOP) which includes sales revenue and value of goods in inventory

- Rucker plan
  - A ratio is calculated that expresses the value of production required for each dollar of total wage bill

- Improshare (Improved productivity through sharing)
  - Any savings arising from production of agreed-upon output in fewer than expected hours is shared by firm and workers

Gain-Sharing Plans

Two major components are vital for success of a Rucker or Scanlon plan.

- A productivity norm
  - Requires effective measurement of base-year data, and
  - acceptance by workers and management of this standard for calculating bonuses.
- Effective worker committees
  - Their primary function is reviewing suggestions on how to improve productivity or reduce costs.

Profit-Sharing Plans

- Focus on a predetermined index of profitability.
- However, most employees do not feel their jobs have a direct impact on profits.
- The trend is to combine the best of gain-sharing and profit-sharing plans.
  - A company specifies a funding formula for any variable payout linked to some profit measure.

Earnings-at-Risk Plans

- Success sharing plan
  - Employee base pay is constant
  - Variable pay increases in successful years
  - No reduction in base pay and no variable pay in poorly-performing years
- Risk sharing plan
  - Base pay is reduced by some amount relative to the level that would be offered in a success-sharing plan
  - These plans shift part of the risk from the company to the employee.
  - May result in decreased employee satisfaction and higher turnover.

Explosive Interest in Long-Term Incentive Plans

- Focus on performance beyond one-year.
- Recent growth in LTI plans is spurred by a desire to motivate longer-term value creation.
  - There is very little evidence that stock ownership leads to better corporate performance.
  - Some evidence that stock ownership increases internal growth.

Explosive Interest in Long-Term Incentive Plans

- Stock options:
  - Most common type of long-term incentive
  - Right to purchase stock at a specified price for a fix time period.

- Broad-based option plans (BBOPs):
  - stock options are granted to a wide variety of employees and not just to senior executives.
  - Can reinforce strong emphasis on performance or inspire greater commitment and retention.
- Employee Stock Ownership Plans (ESOPs)
  - Generate long-term effects.
  - Foster employee willingness to participate in the decision-making process.
  - Have little impact on productivity or profit.

Special Groups

- Special groups share two characteristics: they are strategically important to the company, and their positions hold built in conflict.
- Specific groups receive special treatment
  - In the form of add-on packages not received by other employees
  - Or as compensation components entirely unique in the organization
- They include: Supervisors, Corporate Directors, Executives, Professional Employees, Salespeople and Contingent Workers

Compensation Strategy for Supervisors

- Pay strategies
  - Key base salaries of supervisors to an amount exceeding the top-paid subordinate in the unit
  - Pay supervisors for scheduled overtime

- A trend in supervisory compensation is increased use of variable pay

Compensation Strategy for Corporate Directors

- A board of directors provides strategic advice, usually 8 – 11 directors
- Boards now include more outside directors than inside directors
- Along with shift in duties, pay has moved towards pay for performance
- Stock options have gained prominence in the corporate directors’ package

Executive Compensation

- The disconnect between pay and performance of executives has been a source of contention for decades.
- Compensation committees are important in determining executive base pay.
- A common committee approach is setting compensation in the middle of best/worst major competitors.
  - Higher compensation for those likely to be raided.
  - Larger companies tend to pay higher.
- Components include base salary, annual bonuses, long-term incentives, benefits and perquisites

Compensation Strategy for Professional Employees

- Problems in designing pay
  - Salary plateaus due to knowledge obsolescence of mature professionals
  - Dual-career ladder shows two different ways of progressing in an organization

- Reward Components
  - Performance-based incentives, e.g. profit sharing, stock ownership
  - Bonuses: linked to company profits or personal performance; incentives linked to completion of projects on or before deadlines

- Perks based on unique needs

- Management ladder versus technical ladder

Compensation Strategy for Salespeople

- Growing trend toward linking sales compensation to customer satisfaction measures
- This profession requires high initiative and low supervision.
- Standard compensation might not work
  - More reliance on incentive payments tied to individual performance
- Sales jobs do not fit with either straight salary or straight commission packages. Combination plans are often used.
- High demand products rely more on base pay while incentives increase with sales ability.

Key Factors: Designing a Sales Compensation Plan

The nature of people who enter sales	Organizational strategy	Market maturity
Competitor practices	Economic environment	Product to be sold

Compensation Strategy for Contingent Workers

- Defined as anyone hired
  - through a temporary help agency,
  - on an on-call basis, or
  - as an independent contractor.

- Companies are hiring temporary workers which afford flexibility in the size of the workforce in response to market changes.

- Typical salary arrangements
  - Workers hired through temporary-help agency and on-call basis often earn less
  - As the employee status is temporary and benefits are less or nonexistent

Contingent Workers

- A major compensation problem is equity.
- Employers deal with inequity on two fronts.
  - One way is to view contingent workers as a pool of candidates for future permanent hire.
  - A second way is to champion the idea of boundary-less careers.
    - Here, contingent status is viewed as part of a fast-track developmental sequence.
    - Lower wages are offset by opportunities for rapid development of skills.

Summary

- Incentive plans can be individual or group, short-term, or long-term. Examples of short-term individual incentive plans include merit, lump sum bonuses, individual spot awards and individual incentive plans.
- Group incentive plans can be gain-sharing plans, profit-sharing plans or earnings-at-risk plans. Five causes of problems with team compensation systems are the need for different compensation programs for different types of teams, the loss of motivational impact if the team is very large, overly complex team compensation plans, lack of control by teams over what they are measured on, and poor communication of team-based plans.
- Key issues in designing a gain-sharing plan are strength of reinforcement, productivity standards, sharing the gains between management and workers, scope of the formula, perceived fairness of the formula, ease of administration, and production variability.

Summary (cont’d)

- Stock options provide an employee with the right to purchase company stock at a specified price at a future time. Broad-based stock option plans are stock grants to employees at all levels over a specified time frame. Employee stock ownership plans offer employees the opportunity to purchase company stock, often partially or fully matched by employer-paid stock for the employee.
- The five basic elements of executive compensation packages are base salary, short-term (annual) incentives or bonuses, long-term incentives and capital accumulation plans, executive benefits, and perquisites.
- Dual career ladders are different ways of progressing in an organization, one through a managerial ladder, the other through a scientific ladder. This approach helps to deal with the plateauing effect of gradual technological obsolescence and accommodates the opportunity for mature scientists and engineers to switch to the management ladder.