



**human**

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tenth edition

# **resource management**

Chapter **12**

Part **4** Compensation

## **Pay for Performance and Financial Incentives**

## *After studying this chapter, you should be able to:*

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- 1. Discuss the main incentives for individual employees.*
- 2. Discuss the pros and cons of incentives for salespeople.*
- 3. Name and define the most popular organization-wide variable pay plans.*
- 4. Describe the main incentives for managers and executives.*
- 5. Outline the steps in developing effective incentive plans.*

# Motivation, Performance, and Pay

## ➤ *Incentives*

- Financial rewards paid to workers whose production exceeds a predetermined standard.

## ➤ *Frederick Taylor*

- Popularized scientific management and the use of financial incentives in the late 1800s.
  - Systematic soldiering: the tendency of employees to work at the slowest pace possible and to produce at the minimum acceptable level.

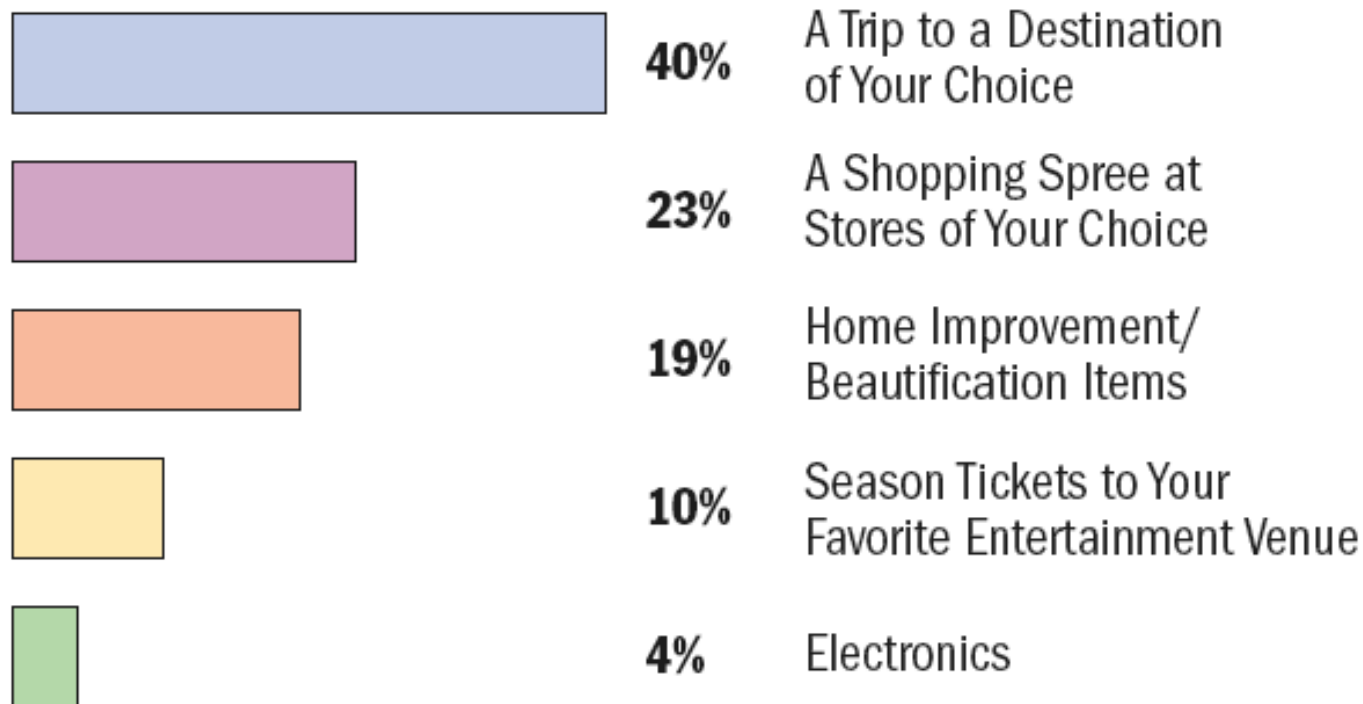
# Individual Differences

## ➤ *Law of individual differences*

- The fact that people differ in personality, abilities, values, and needs.
- Different people react to different incentives in different ways.
- Managers should be aware of employee needs and fine-tune the incentives offered to meets their needs.
- Money is not the only motivator.

# Employee Preferences for Noncash Incentives

## Employee Preferences for Noncash Incentives



\*The survey polled a random nationwide sample of 1,004 American adults. Among those polled, 851 were working or retired Americans, whose responses represent the percentage cited in this release. The survey was conducted June 4–7, 1999, by Wirthlin Worldwide. The margin of error is  $\pm 3.1\%$ . Responses total less than 100 because 4% responded “something else”.

# Needs and Motivation

## ➤ *Abraham Maslow's Hierarchy of Needs*

- Five increasingly higher-level needs:
  - physiological (food, water, sex)
  - security (a safe environment)
  - social (relationships with others)
  - self-esteem (a sense of personal worth)
  - self-actualization (becoming the desired self)
- Lower level needs must be satisfied before higher level needs can be addressed or become of interest to the individual.

# Needs and Motivation (cont'd)

## ➤ *Herzberg's Hygiene–Motivator theory*

### – Hygienes (extrinsic job factors)

- Inadequate working conditions, salary, and incentive pay can cause dissatisfaction and prevent satisfaction.

### – Motivators (intrinsic job factors)

- Job enrichment (challenging job, feedback and recognition) addresses higher-level (achievement, self-actualization) needs.
- The best way to motivate someone is to organize the job so that doing it helps satisfy the person's higher-level needs.

# Needs and Motivation (cont'd)

## ➤ *Edward Deci*

- Intrinsically motivated behaviors are motivated by the underlying need for competence and self-determination.
- Offering an extrinsic reward for an intrinsically-motivated act can conflict with the acting individual's internal sense of responsibility.
- Some behaviors are best motivated by job challenge and recognition, others by financial rewards.



# Instrumentality and Rewards

## ➤ *Vroom's Expectancy Theory*

- A person's motivation to exert some level of effort is a function of three things:
  - **Expectancy:** that effort will lead to performance.
  - **Instrumentality:** the connection between performance and the appropriate reward.
  - **Valence:** the value the person places on the reward.
- **Motivation =  $E \times I \times V$** 
  - If any factor (E, I, or V) is zero, then there is no motivation to work toward the reward.
  - Employee confidence building and training, accurate appraisals, and knowledge of workers' desired rewards can increase employee motivation.

# Types of Incentive Plans

## ➤ *Pay-for-performance plans*

### – Variable pay (organizational focus)

- A team or group incentive plan that ties pay to some measure of the firm's overall profitability.

### – Variable pay (individual focus)

- Any plan that ties pay to individual productivity or profitability, usually as one-time lump payments.

# Types of Incentive Plans (cont'd)

## ➤ *Pay-for-performance plans*

- Individual incentive/recognition programs
- Sales compensation programs
- Team/group-based variable pay programs
- Organizationwide incentive programs
- Executive incentive compensation programs

# Individual Incentive Plans

## ➤ *Piecework Plans*

- The worker is paid a sum (called a *piece rate*) for each unit he or she produces.
  - **Straight piecework:** A fixed sum is paid for each unit the worker produces under an established piece rate standard. An incentive may be paid for exceeding the piece rate standard.
  - **Standard hour plan:** The worker gets a premium equal to the percent by which his or her work performance exceeds the established standard.

# Individual Incentive Plans (cont'd)

## ➤ *Pro and cons of piecework*

- Easily understandable, equitable, and powerful incentives
- Employee resistance to changes in standards or work processes affecting output
- Quality problems caused by an overriding output focus
- Possibility of violating minimum wage standards
- Employee dissatisfaction when incentives either cannot be earned due to external factors or are withdrawn due to a lack of need for output

# Individual Incentive Plans (cont'd)

## ➤ *Merit pay*

- A permanent cumulative salary increase the firm awards to an individual employee based on his or her individual performance.

## ➤ *Merit pay options*

- Annual lump-sum merit raises that do *not* make the raise part of an employee's base salary.
- Merit awards tied to both individual and organizational performance.

# Lump-Sum Award Determination Matrix (an example)

The Employee's Performance rating (Weight = .50)	The Company's Performance (Weight = 0.50)				
	Outstanding	Excellent	Good	Marginal	Unacceptable
Outstanding	1.00	0.90	0.80	0.70	0.00
Excellent	0.90	0.80	0.70	0.60	0.00
Good	0.80	0.70	0.60	0.50	0.00
Marginal	—	—	—	—	—
Unacceptable	—	—	—	—	—

To determine the dollar value of each employee's incentive award: (1) multiply the employee's annual, straight-time wage or salary as of June 30 times his or her maximum incentive award and (2) multiply the resultant product by the appropriate percentage figure from this table. For example, if an employee had an annual salary of \$20,000 on June 30 and a maximum incentive award of 7% and if her performance and the organization's performance were both "excellent," the employee's award would be \$1,120: ( $\$20,000 \times 0.07 \times 0.80 = \$1,120$ ).

Table 12-1

# Individual Incentive Plans (cont'd)

## ➤ *Incentives for professional employees*

- Professional employees are those whose work involves the application of learned knowledge to the solution of the employer's problems.
  - Lawyers, doctors, economists, and engineers.

## ➤ *Possible incentives*

- Bonuses, stock options and grants, profit sharing
- Better vacations, more flexible work hours
- improved pension plans
- Equipment for home offices



# Individual Incentive Plans (cont'd)

## ➤ *Recognition-based awards*

- Recognition has a positive impact on performance, either alone or in conjunction with financial rewards.
  - Combining financial rewards with nonfinancial ones produced performance improvement in service firms almost twice the effect of using each reward alone.
- Day-to-day recognition from supervisors, peers, and team members is important.

# Individual Incentive Plans (cont'd)

## ➤ *Online award programs*

- Programs offered by online incentives firms that improve and expedite the awards process.
  - Broader range of awards
  - More immediate rewards

## ➤ *Information technology and incentives*

- Enterprise incentive management (EIM)
  - Software that automates the planning, calculation, modeling and management of incentive compensation plans, enabling companies to align their employees with corporate strategy and goals.

# Incentives for Salespeople

## ➤ *Salary plan*

### – Straight salaries

- Best for: prospecting (finding new clients), account servicing, training customer's salesforce, or participating in national and local trade shows.

## ➤ *Commission plan*

### – Pay is only a percentage of sales

- Keeps sales costs proportionate to sales revenues.
- May cause a neglect of nonselling duties.
- Can create wide variation in salesperson's income.
- Likelihood of sales success may linked to external factors rather than to salesperson's performance.
- Can increase turnover of salespeople.

# Incentives for Salespeople (cont'd)

## ➤ *Combination plan*

- Pay is a combination of salary and commissions, usually with a sizable salary component.
- Plan gives salespeople a floor (safety net) to their earnings.
- Salary component covers company-specified service activities.
- Plans tend to become complicated, and misunderstandings can result.

# Specialized Combination Plans

- *Commission-plus-drawing-account plan*
  - Commissions are paid but a draw on future earnings helps the salesperson to get through low sales periods.
- *Commission-plus-bonus plan*
  - Pay is mostly based on commissions.
  - Small bonuses are paid for directed activities like selling slow-moving items.

# Setting Sales Quotas

- *Whether to lock quotas in for a period of time?*
- *Have quotas been communicated to the salesforce within one month of the start of the period?*
- *Does the salesforce know exactly how its quotas are set?*
- *Do you combine bottom-up information (like account forecasts) with top-down requirements (like the company business plan)?*
- *Do 60% to 70% of the salesforce generally hit their quota?*
- *Do high performers hit their targets consistently?*
- *Do low performers show improvement over time?*
- *Are quotas stable through the performance period?*
- *Are returns and debookings reasonably low?*
- *Has your firm generally avoided compensation-related lawsuits?*
- *Is 10% of the salesforce achieving higher performance than previously?*
- *Is 5% to 10% of the salesforce achieving below quota performance and receiving coaching?*

# Team/Group Variable Pay Incentive Plans

- *Team or group incentive plan*
  - A plan in which a production standard is set for a specific work group, and its members are paid incentives if the group exceeds the production standard.

# How to Design Team Incentives

## ➤ *Set individual work standards*

- Set work standards for each team member and then calculate each member's output.
- Members are paid based on one of three formulas:
  - All members receive the same pay earned by the highest producer.
  - All members receive the same pay earned by the lowest producer.
  - All members receive same pay equal to the average pay earned by the group.



# How to Design Team Incentives (cont'd)

- *Use an engineered production standard based on the output of the group as a whole.*
  - All members receive the same pay, based on the piece rate for the group's job.
    - This group incentive can use the piece rate or standard hour plan, but the latter is more prevalent.
- *Tie rewards to goals based on an overall standard of group performance*
  - If the firm reaches its goal, the employees share in a percentage of the improvement (in labor costs saved).

# Organizationwide Variable Pay Plans

## ➤ *Profit-sharing plans*

### – Cash plans

- Employees receive cash shares of the firm's profits at regular intervals.

### – The Lincoln incentive system

- Profits are distributed to employees based on their individual merit rating.

### – Deferred profit-sharing plans

- A predetermined portion of profits is placed in each employee's account under a trustee's supervision.

# Organizationwide Variable Pay Plans (cont'd)

## ➤ *Employee stock ownership plan (ESOP)*

- A corporation annually contributes its own stock—or cash (with a limit of 15% of compensation) to be used to purchase the stock—to a trust established for the employees.
- The trust holds the stock in individual employee accounts and distributes it to employees upon separation from the firm if the employee has worked long enough to earn ownership of the stock.

# Advantages of ESOPs

## ➤ *Employees*

- ESOPs help employees develop a sense of ownership in and commitment to the firm, and help to build teamwork.
- No taxes on ESOPs are due until employees receive a distribution from the trust, usually at retirement when their tax rate is lower.

## ➤ *Shareholders of closely held corporations*

- Helps to diversify their assets by placing their shares of company stock into an ESOP trust and allowing them to purchase other marketable securities for themselves in their place.

# Advantages of ESOPs (cont'd)

## ➤ *The company*

- A tax deduction equal to the fair market value of the shares transferred to the trustee.
- An income tax deduction for dividends paid on ESOP-owned stock.
- The Employee Retirement Income Security Act (ERISA) allows a firm to borrow against employee stock held in trust and then repay the loan in pretax rather than after-tax dollars.
- Firms offering ESOP had higher shareholder returns than did those not offering ESOPs.

# Scanlon Plan

- *Scanlon plan (Joseph Scanlon, 1937)*
  - **Philosophy of cooperation**
    - No “us” and “them” attitudes that inhibit employees from developing a sense of ownership in the company.
  - **Identity**
    - Employees understand the business’s mission and how it operates in terms of customers, prices, and costs.
  - **Competence**
    - The plan depends a high level of competence from employees at all levels.
  - **Sharing of benefits formula**
    - Employees share in 75% of the savings (reduction in payroll expenses divided by total sales).

# Gainsharing Plans

## ➤ *Gainsharing*

- An incentive plan that engages many or all employees in a common effort to achieve a company's productivity objectives.
- Cost-savings gains are shared among employees and the company.

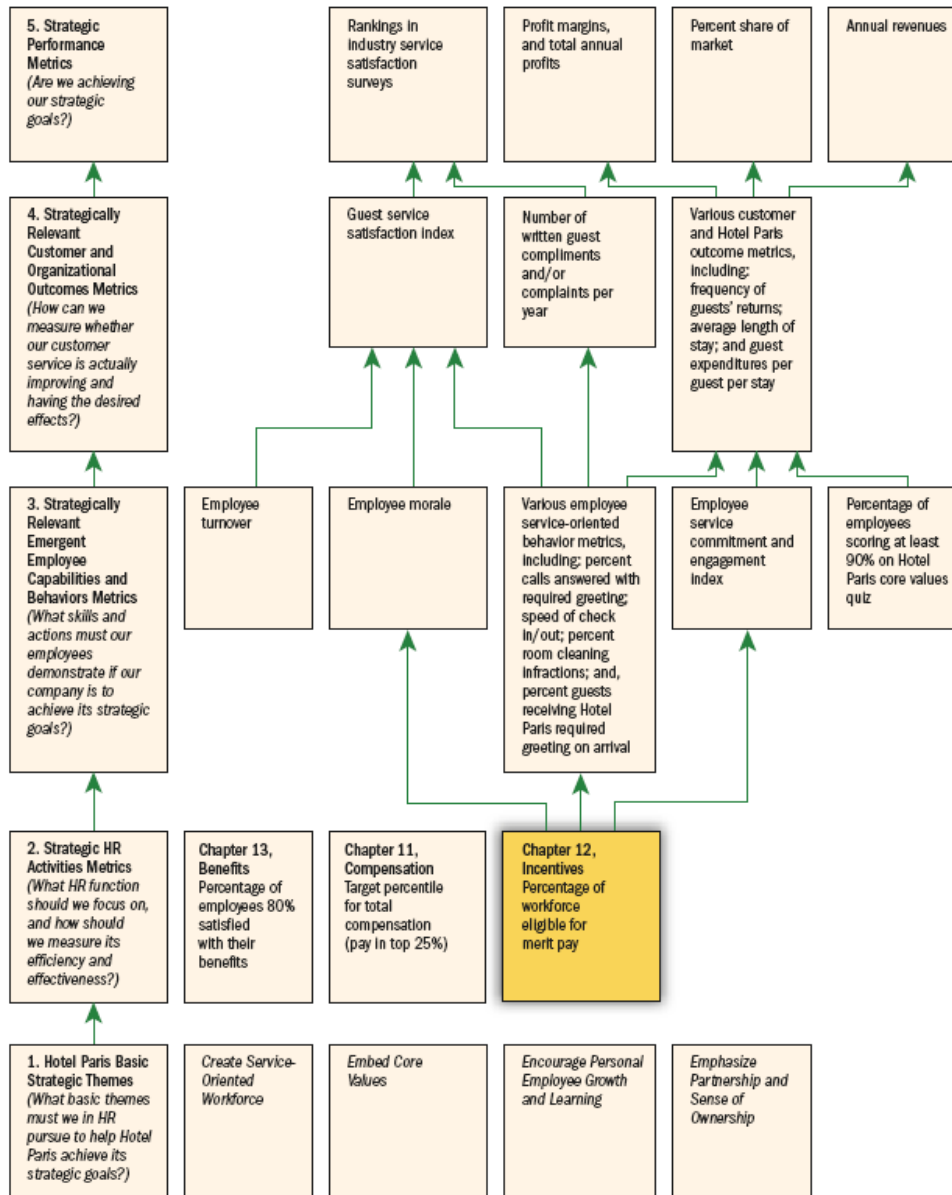
## ➤ *Rucker plan*

## ➤ *Improshare*

# Implementing a Gainsharing Plan

1. *Establish general plan objectives.*
2. *Choose specific performance measures.*
3. *Decide on a funding formula.*
4. *Decide on a method for dividing and distributing the employees' share of the gains.*
5. *Choose the form of payment.*
6. *Decide how often to pay bonuses.*
7. *Develop the involvement system.*
8. *Implement the plan.*





## HR Scorecard for Hotel Paris International Corporation\*

Note: \*(An abbreviated example showing selected HR practices and outcomes aimed at implementing the competitive strategy, "To use superior guest services to differentiate the Hotel Paris properties and thus increase the length of stays and the return rate of guests and thus boost revenues and profitability")

Figure 12–2

# At-Risk Variable Pay Plans

- *At-risk variable pay plans that put some portion of the employee's weekly pay at risk.*
  - If employees meet or exceed their goals, they earn incentives.
  - If they fail to meet their goals, they forgo some of the pay they would normally have earned.

# Short-Term Incentives for Managers And Executives

## ➤ *Annual bonus*

- Plans that are designed to motivate short-term performance of managers and are tied to company profitability.
  - Eligibility basis: job level, base salary, and impact on profitability
  - Fund size basis : nondeductible formula (net income) or deductible formula (profitability)
  - Individual awards: personal performance/contribution

# Multiplier Approach to Determining Annual Bonus

*Company Performance (based on sales targets, weight .50)*

		Excellent	Good	Fair	Poor
Individual Performance	Excellent	1.00	.90	.80	.70
(based on appraisal. weight .50)	Good	.80	.70	.60	.50
	Fair	0.00	0.00	0.00	0.00
	Poor	0.00	0.00	0.00	0.00

**Note:** To determine the dollar amount of a manager's award, multiply the maximum possible (target) bonus by the appropriate factor in the matrix.

Table 12-2

# Long-Term Incentives for Managers And Executives

## ➤ *Stock option*

- The right to purchase a specific number of shares of company stock at a specific price during a specific period of time.
  - Nonqualified stock option
  - Indexed option
  - Premium priced option
- Options have no value (go “underwater”) if the price of the stock drops below the option’s strike price (the option’s stock purchase price).

# Long-Term Incentives for Managers And Executives (cont'd)

## ➤ *Other plans*

- Key employee program
- Stock appreciation rights
- Performance achievement plan
- Restricted stock plans
- Phantom stock plans

## ➤ *Performance plans*

- Plans whose payment or value is contingent on financial performance measured against objectives set at the start of a multi-year period.

# Other Executive Incentives

## ➤ *Golden parachutes*

- Payments companies make to departing executives in connection with a change in ownership or control of a company.

## ➤ *Guaranteed loans to directors*

- Loans provided to buy company stock.
- A highly risky and now frowned upon practice.

# Creating an Executive Compensation Plan

- *Define the strategic context for the executive compensation program.*
- *Shape each component of the package to focus the manager on achieve the firm's strategic goals.*
- *Create a stock option plan to meet the needs of the executives and the company and its strategy.*
- *Check the executive compensation plan for compliance with all legal and regulatory requirements and for tax effectiveness.*
- *Install a process for reviewing and evaluating the executive compensation plan whenever a major business change occurs.*



# Why Incentive Plans Fail

- *Performance pay can't replace good management.*
- *You get what you pay for.*
- *“Pay is not a motivator.”*
- *Rewards punish.*
- *Rewards rupture relationships.*
- *Rewards can have unintended consequences.*
- *Rewards may undermine responsiveness.*
- *Rewards undermine intrinsic motivation.*

# Implementing Effective Incentive Plans

- *Ask: Is effort clearly instrumental in obtaining the reward?*
- *Link the incentive with your strategy.*
- *Make sure effort and rewards are directly related.*
- *Make the plan easy for employees to understand.*
- *Set effective standards.*
- *View the standard as a contract with your employees.*
- *Get employees' support for the plan.*
- *Use good measurement systems.*
- *Emphasize long-term as well as short-term success.*
- *Adopt a comprehensive, commitment-oriented approach.*

## *HR Activities that Build Commitment*

- Clarifying and communicating the goals and mission of the organization.
- Guaranteeing organizational justice.
- Creating a sense of community by emphasizing teamwork and encouraging employees to interact.
- Supporting employee development by emphasizing promotion from within, developmental activities, and career-enhancing activities.
- Generally committing to “people-first values.”

# Express Auto Compensation System

<b>Express Auto Team</b>	<b>Responsibility of Team</b>	<b>Current Compensation Method</b>
1. Sales force	Persuade buyer to purchase a car.	Very small salary (minimum wage) with commissions. Commission rate increases with every 20 cars sold per month.
2. Finance office	Help close the sale; persuade customer to use company finance plan.	Salary, plus bonus for each \$10,000 financed with the company.
3. Detailing	Inspect cars delivered from factory, clean, and make minor adjustments	Piecework paid on the number of cars detailed per day.
4. Mechanics	Provide factory warranty service, maintenance, and repair.	Small hourly wage, plus bonus based on (1) number of cars completed per day and (2) finishing each car faster than the standard estimated time to repair.
5. Receptionists/phone service personnel	Primary liaison between customer and salesforce, finance, and mechanics.	Minimum wage.

Table 12–3

# Key Terms

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**law of individual differences**

**expectancy**

**instrumentality**

**valence**

**variable pay**

**piecework**

**straight piecework**

**standard hour plan**

**merit pay (merit raise)**

**team or group incentive plan**

**profit-sharing plan**

**employee stock ownership plan (ESOP)**

**Scanlon plan**

**gainsharing plan**

**at-risk variable pay plans**

**annual bonus**

**stock option**

**golden parachutes**