

Rewarding Performance



LEARNING OBJECTIVES

After completing this chapter, you should be able to answer the following questions:

- 1
How are employee compensation and maximization of stockholder wealth related?
- 2
What are the alternative means of rewarding performance?
- 3
Why is there a movement toward rewarding group, as well as individual, performance?
- 4
What are the potential positive and negative consequences of incentive pay programs?
- 5
Why do many financial incentive programs involve shares of, or options for, common stock?
- 6
Of what importance are nonmonetary rewards in motivating managers?
- 7
How do taxes affect the design of compensation plans?
- 8
Why should ethics be considered in designing a compensation package?
- 9
What concerns need to be addressed in developing compensation packages for expatriates?

INTRODUCING

<http://www.meridia.com>

Healthcare organizations that are trying to increase the productivity of their employed physicians often find that the physicians lack sufficient financial incentives and managerial skills to meet desired productivity levels. One health system in the Cleveland, Ohio, area, however, has rejuvenated the performance of its physician network by overhauling its physician compensation program and introducing effective incentives.

Since its formation through the merger of four independent hospitals in the 1980s, Meridia Health System has enjoyed a strong market position in Cleveland's eastern suburbs. Competition in the Cleveland healthcare market, however, has gradually intensified as a result of hospital consolidations, the acquisition of independent hospitals by for-profit systems, and the development of integrated delivery systems (IDS) that incorporate health plans, physician practices, and ancillary services into hospital-owned networks.

In 1992, Meridia decided that to remain competitive it had to develop a primary care physician network to form the core of an IDS. By 1995, through practice acquisitions and expansions, Meridia was operating four primary care practices employing about 40 primary care physicians. An independent company was engaged to provide billing and management services for the network.

All physicians received two- or three-year guaranteed salary and benefit packages. Salaries were based on a review of each physician's existing salary level and years of experience, as well as industry compensation surveys. Benefit packages mirrored those of Meridia's senior executives, though some were modified to fit individual circumstances. Bonuses were available for physicians who met productivity targets. Most of these targets were based on a combination of the historical production level of each individual physician and industry averages.

Meridia executives had assumed that their physician practices would continue to function as they had before they were acquired. This assumption proved faulty for several reasons. First, physician productivity declined. Second, the transition to using contracted billing and management services caused disruptions to routine practice operations. Third, new physicians recruited into the groups placed increased demands on practice resources and absorbed existing and new patient volume. Fourth, as practice sites were expanded or consolidated into new facilities, practice operations were disrupted. Patient volumes dropped in part due to practice location changes. Losses from primary care network operations were in excess of \$100,000 per physician, per year.

SOURCE: Alexandra Davis and C. Thompson Hardy, "New Compensation Model Improves Physician Productivity," *Journal of the Healthcare Financial Management Association* (July 1999), pp. 46-49.

In analyzing its problems and searching for solutions, Meridia Health Systems focused intense scrutiny on its model for evaluating physician compensation. The company determined that revisions in the compensation model were necessary to make physicians' pay more sensitive to the fortunes of the company and its patients. A performance-based pay plan was devised that resulted in some physicians receiving less pay, but that resulted in greater organizational efficiency and more sensitivity of the physicians to productivity and higher quality patient care.

The performance evaluation and reward systems in an organization are the key tools to align the incentives of workers, managers, and owners. When workers help to control costs and the bottom line increases, stockholders benefit through increased dividends and/or stock market prices. Throughout American business management literature, the expressed primary function of managers is to maximize stockholder value or stockholder wealth.

Stockholders are granted this special attention because they (acting through the board of directors) have the unique power to hire, fire, and set compensation

for top managers who, in turn, can hire, fire, and set compensation for workers.¹ Alternatively, workers and managers are self-interested and would prefer to maximize their own wealth rather than that of the stockholders. Consequently, the burden of motivating employees to maximize stockholder wealth is borne by stockholders through specification of managerial pay and other performance rewards and by managers in design of the employee performance measurement and reward system.

Accounting frequently plays a primary role in defining expected performance, monitoring and measuring actual performance, and determining the quantity and quality of appropriate employee rewards. In the two preceding chapters, a variety of techniques to measure employee performance were discussed. This chapter explores the relationship of organizational plans, strategies, and performance to employee rewards as well as the tax and ethical implications of various compensation systems.

COMPENSATION STRATEGY

1

How are employee compensation and maximization of stockholder wealth related?

As noted in previous chapters, many changes (technological advances, globalization, customer and quality orientation) have occurred in business in the recent past. These changes have created problems and opportunities in establishing responsibility and rewarding individuals for organizational performance. Each organization has a unique compensation plan. A rational compensation plan will tie its component elements (organizational goals and strategies, performance measurements, and employee rewards) together into a cohesive package. The relations and interactions among these elements are shown in Exhibit 21–1. In this model, the organizational strategic goals are determined by the board of directors (the governing body representing stockholder interests) and top management. From these strategic goals, the organization's critical success factors are identified and operational performance targets are defined. Operational targets, for example, could include specified annual net income, unit sales of specific products, quality measures, customer service measures, or costs.

The board of directors and top management must also decide on a **compensation strategy** for the organization. This strategy provides a foundation for the compensation plan by addressing the role compensation should play in the organization. This strategy should be made known to everyone, from the board of directors to the lowest-level worker. Many companies establish a **compensation committee** comprised mainly of members of the board of directors. The compensation committee has the responsibility of establishing compensation packages for top management and setting general compensation policies and guidelines. As the accompanying News Note indicates, shareholders may perceive a conflict of interest if the CEO serves on this committee.

The traditional American compensation strategy differentiates among three employee groups that are compensated differently. Top managers' compensation contains a salary element and significant **financial incentives** that are provided for performance above targeted objectives. Usually these targeted objectives are specified in some financial accounting measure such as companywide net income or earnings per share. Middle managers are given salaries with the opportunity for future raises based on some—again, usually accounting-related—measure of performance such as segment income or divisional return on investment. Workers are paid wages (usually specified by union contract or tied to the minimum wage law) for the number of hours worked or production level achieved; current or year-end bonuses may arise when performance is above some specified quantitative mea-

¹ The authors use the term *employees* to refer to all of the personnel of an organization. The terms *workers* and *managers* are used to identify mutually exclusive groups of employees.

compensation strategy

compensation committee

<http://www.aflcio.org>

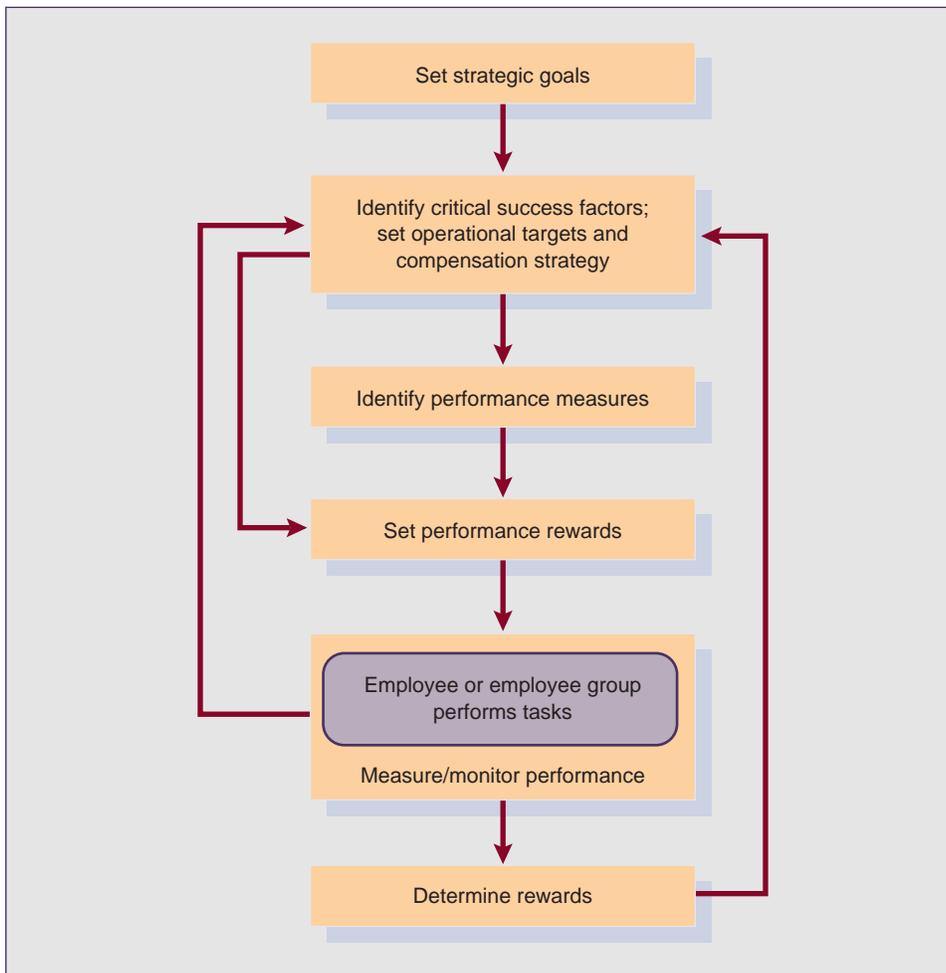
<http://www.nike.com>

<http://www.amd.com>

financial incentive

EXHIBIT 21-1

Plan-Performance-Reward Model



ETHICS



NEWS NOTE

Should CEOs Help Set Their Own Pay?

At a surprising number of companies, the chief executive officer ignores an obvious conflict of interest by serving on the board's compensation committee.

The practice angers activist investors, who have long clamored for truly independent compensation committees. "This is the most egregious expression of runaway executive pay," says William Patterson, director of the AFL-CIO's Office of Investment, which advises union pension funds. "These [corporate chiefs] have no shame."

In early 1999, Mr. Patterson wrote 21 CEOs who still served on their company's pay panel, demanding that they give up their seats by the company's next annual meeting. Otherwise, "we will begin communicating with other institutional investors about appropriate next steps to restore integrity and independence to the corporate governance process." These steps might include filing a

shareholder resolution or raising a ruckus at the annual meeting. Mr. Patterson received responses from a dozen chief executives, most of whom said they were leaving the pay panel or no longer served on it.

Union-backed proposals sought independent compensation committees at seven companies in 1998; they won support that ranged from 15.4% of stockholder votes at Nike Inc. to 30.9% at Advanced Micro Devices Inc., the IRRC reports.

Business chiefs with seats on pay panels scoff at such criticism, saying they simply avoid voting on their own compensation.

SOURCE: John S. Lubin, "In Whose Interest? Compensation Committees Are Supposed to be Independent; That May be Tough When the CEO Is a Member," *The Wall Street Journal* (April 8, 1999), p. R4. Permission conveyed through the Copyright Clearance Center.

sure. If provided, worker performance bonuses are usually fairly small relative to the level of wages. Significant incentive pay is generally limited to top management (and possibly the sales force)—regardless of the levels of employees who may have contributed to increased profits.

The traditional compensation system provides little motivation for lower-level managers to improve organizational performance. However, the trend in pay schemes is to tie pay to performance by providing incentive-based compensation to all employees, regardless of organizational level or function. A recent survey of more than 1,800 employers found that 51 percent said they give nonmanagement, nonsales employees compensation tied to individual or group performance.² As indicated in the accompanying News Note, the increasing use of pay-for-performance plans is not limited to U.S. firms.

<http://www.towers.com>

PAY-FOR-PERFORMANCE PLANS

2

What are the alternative means of rewarding performance?

Compensation plans should encourage higher levels of employee performance and loyalty, while concurrently lowering overall costs and raising profits. Such plans must encourage behavior essential to achieving organizational goals and maximizing stockholder value.

NEWS NOTE



INTERNATIONAL

New Fashion Trend in Europe: Variable Pay

Pay-for-performance plans are at the forefront of a trend that is sweeping across Europe according to a study by Towers Perrin, a human-resources consulting firm.

In findings from a survey of 460 companies in 13 countries, performance-based pay now dominates throughout Europe, with 58% of survey participants now giving wholly merit-based pay increases to senior executives and only a quarter still using “across-the-board” pay increases for all staffers.

“The U.S. pay-for-performance model, which was first introduced in the U.K., is now becoming common throughout Continental Europe,” says the study’s author, Duncan Brown, a principal of Towers Perrin in London.

The study found that European employers have been steadily increasing their use of variable pay since Tower Perrin’s last survey in 1996. Then, for example, senior executives of the companies surveyed received 20% of their total compensation in variable pay, such as bonuses and stock options. In 1999, variable pay rose to 25% of total compensation among senior executives. By 2002, it is expected to climb to 31%.

Bonus plans, profit sharing, and stock-option programs are all forms of variable pay. They are being embraced by European companies as a way of linking business goals—such as a higher stock price or profit—with pay. By making a larger percentage of its total employee compensation variable pay, companies can protect themselves in the event of a business downturn and reward employees when the business is performing well.

That explains why the use of variable pay is seeping down to the ranks of ordinary workers. Based on its study, Tower Perrin forecasts that variable pay will account for more than 10% of the pay of nonmanagement employees in Europe by 2002, double the 5% of 1999.

More changes are coming: Almost a third of the study participants say they are considering removing base-pay increases altogether in favor of wholly variable systems of paying employees.

SOURCE: Julia Flynn, “Use of Performance-Based Pay Spreads Across Continental Europe, Survey Says,” *The Wall Street Journal* (November 17, 1999), p. D1. Permission conveyed through the Copyright Clearance Center.

² Albert R. Karr, “A Special News Report about Life on the Job—and Trends Taking Shape There,” *The Wall Street Journal* (April 6, 1999), p. A1.



These sweat shop workers are being paid for "performance" in that they receive pay for each unit worked on. However, given the paltry sums received, their compensation system is both unfair and unethical.

Correlation with Organizational Goals

In a pay-for-performance plan, the defined performance measures must be highly correlated with the organization's operational targets. Otherwise, suboptimization may occur and workers could earn incentive pay even though the broader organizational objectives are not achieved. More than any other goal or objective, maximization of shareholder wealth drives the design of reward systems.

Appropriate Time Horizon

A second important consideration when designing a performance-based system involves the time horizon. One recent criticism leveled at American businesses is that the measures (such as annual net income) used to monitor performance are too focused on the short run. The primary objective of American business, maximization of shareholder wealth, is inherently a long-run consideration. The message of this criticism is that short-run measures are not necessarily viable proxies for long-run wealth maximization. In particular, short-term profits may be garnered at the expense of long-term growth.

Pay-for-performance criteria should encourage workers to adopt a long-run perspective. Many financial incentives now involve shares of corporate common stock or stock options. When employees become stockholders in their employer company, they tend to develop the same perspective as other stockholders: long-run wealth maximization. Exhibit 21-2 (page 934) provides a breakdown of compensation received by some of the highest paid executives in the United States as determined in a recent survey. For many companies, a large portion of the compensation is paid in the form of stock and stock options to link the executive's incentives to those of shareholders.

Subunit Mission

Each organizational subunit has a unique mission and must possess unique competencies. Both the performance measurement system and the reward structure should be crafted with the mission of the subunit in mind. What is measured and

EXHIBIT 21-2

How America's Top Executives Are Paid

Name	Salary	Bonus	Stock-Based Compensation
Stephen M. Case America Online	\$ 427,000	\$ 750,000	\$158,057,000
Charles Heimbold, Jr. Bristol-Myers Squibb	1,250,000	1,944,000	30,372,000
Walter V. Shipley Chase Manhattan	1,031,000	5,198,000	3,666,000
Michael S. Dell Dell Computer	788,000	2,000,000	0
Kenneth L. Lay Enron	1,267,000	3,150,000	13,095,000
Jacques Nasser Ford Motor	1,050,000	5,000,000	0
Louis V. Gerstner, Jr. IBM	1,875,000	7,500,000	32,802,000
Floyd Hall K-mart	1,300,000	690,000	0
William H. Gates Microsoft	369,000	173,000	0
Philip J. Purcell Morgan Stanley Dean Witter	775,000	8,113,000	40,051,000
William C. Steere, Jr. Pfizer	1,380,000	2,579,000	21,006,000
Timothy Koogle Yahoo!	195,000	0	7,318,000

SOURCE: "Nifty Fifty U.S. (CEO's Pay at Some of the Most Powerful Firms in the U.S.)," *Forbes* (May 17, 1999), <http://www.forbes.com/forbesglobal/99/0517/0210059table.htm>. Reprinted by permission of Forbes Global Business & Finance Magazine. © Forbes Global Inc., 1999.

rewarded affects the focus of the subunit employees, and the focus of the employees should be specifically on factors that determine the success of each subunit's operations. Exhibit 21-3 indicates how the form of reward is influenced by the subunit mission.

EXHIBIT 21-3

Different Strategic Missions: Implications for Incentive Compensation

	Build		Hold		Harvest
Percent of compensation as bonus	Relatively high	→			Relatively low
Bonus criteria	Emphasis on nonfinancial criteria	→			Emphasis on financial criteria
Bonus determination approach	More subjective	→			More formula-based
Frequency of bonus payment	Less frequent	→			More frequent

SOURCE: Vijay Govindarajan and John K. Shank, "Strategic Cost Management: Tailoring Controls to Strategies," *Journal of Cost Management* (Fall 1992), pp. 14-24. © 1992 Warren Gorham & Lamont. Reprinted with permission of RIA.

Consideration of Employee Age

Employee age is another important factor in designing employee incentive plans. Younger employees, for natural reasons, may have a longer term perspective than older employees who expect to retire from the firm within a few years. In designing employee incentives, this difference in perspective between younger and older employees should be given due regard.

To illustrate how age can affect decision processes, consider the case of Connie Taylor, a division manager evaluating two new projects. Each project would require an initial investment of \$250,000. The projects promise to generate the following annual net returns:

Year	Project 1	Project 2
1	\$(125,000)	\$150,000
2	(75,000)	100,000
3	0	0
4	150,000	(50,000)
5	300,000	(150,000)
6	250,000	(20,000)
Total	<u>\$ 500,000</u>	<u>\$ 30,000</u>

Assume that, based on the net present value criterion, Project 1 is acceptable and Project 2 is unacceptable. Based on other criteria, however, both projects are acceptable. Further, assume that Connie is evaluated, in part, based on the return on investment (ROI) generated by her division. If Connie is two years from retirement, she would be reluctant to invest in Project 1 because she would never realize the positive ROI effects of this project. The positive benefits from Project 1 (or the negative effects of Project 2) would be realized by her successor. Connie would be more enthusiastic about investing in Project 2, because in the two years prior to her retirement, her division's ROI would be enhanced. A younger manager with a longer term time perspective is more likely to find Project 1 acceptable and Project 2 unacceptable.

Balance Group and Individual Benefits

Another consideration in designing worker incentives is balancing the incentives provided for both groups (or teams) and individuals. In automated production systems, workers devote more time to indirectly monitoring and controlling machinery and are, therefore, less directly involved in hands-on production. At the same time, many organizational and managerial philosophies stress group performance and the performance of work in teams.

Incentives for small groups and individuals are often virtual substitutes. As the group grows larger, incentives must be in place for both the group and the individual. Group incentives are necessary to encourage cooperation among workers. On the other hand, if only group incentives are offered, the incentive compensation system may be ineffective because the reward for individual effort goes to the group. The larger the group size, the smaller the individual's share of the group reward becomes. Eventually, individual workers will be encouraged to shirk or take a "free ride" on the group. **Shirking** occurs when individuals perceive their proportional shares of the group reward as insufficient to compensate for their efforts. Managing the balance between individual and group rewards requires skill and a careful consideration of incentives.

Management Ownership

A final consideration in designing a performance reward system for upper management is to increase the extent of management ownership. Unlike many small

3

Why is there a movement toward rewarding group, as well as individual, performance?

shirking

firms, managers of large firms are often not owners. When the managers and owners are different groups, a new set of organizational performance issues emerges. The two groups do not automatically have compatible interests with respect to using organizational resources. Consequently, incentive systems must be designed to align the interests of the two groups.

Many companies are now mandating that top management own common stock. However, many companies do not have a similar requirement for their outside directors. As the accompanying News Note indicates, some companies are rethinking this policy.

CONSIDERATIONS IN SETTING PERFORMANCE MEASURES

4

What are the potential positive and negative consequences of incentive pay programs?

Once the target objectives and compensation strategy are known, performance measures for individual employees or employee groups can be determined based on their required contributions to the operational plan. Performance measures should, directly or indirectly, link individual actions with the basic business strategies. As discussed in the previous two chapters, employee performance is typically measured relative to some designated set of financial and nonfinancial performance standards.

Degree of Control over Performance Output

As companies shift from evaluating workers through observing their inputs to evaluating workers based on their outputs, new problems for the pay and performance relationship are created. Earlier chapters stressed the importance of evaluating managers and workers only on the basis of controllable factors. Most performance measures tend to capture results that are a function of both controllable and noncontrollable factors.

NEWS NOTE



GENERAL BUSINESS

Paying the Board of Directors

The use of stock, stock options and other incentives is commonplace to attract and retain top performers in an organization. Despite this push to keep top employees loyal and content, many companies continue to throw large amounts of cash compensation at their outside directors.

These individuals, who make the decisions that drive the organization's direction and focus, often do not have to worry about the effect their decisions will have on the company's performance. Recently, however, many companies have turned to making the compensation of outside directors dependent upon the performance of the company.

Traditionally, a director's compensation package includes cash payment for retainers and meeting fees. A stock component typically is included in the compensation package as an additional incentive, and benefit packages often are offered to those on the board.

A recent study by Pearl Meyer & Partners Inc., an executive compensation consulting firm, revealed that stock

payments to outside directors in the 200 largest firms in the United States has grown three-fold from 1995 through 1999, with stock-based pay representing 60 percent of an outside director's pay.

The survey also showed that in 1999, 95 percent of companies paid at least some portion of director compensation in stock. Stock options were used by 63 percent of corporations utilizing equity pay, while "full value shares," in the form of restricted and unrestricted stock and deferred stock, were used by 78 percent of companies.

Rhoda Edelman, managing director of Pearl Meyer & Partners, said full value shares, as opposed to option grants, are the way to go in paying outside directors. This puts the directors immediately in an ownership position, while further emphasizing their responsibility to the success of the company.

SOURCE: Jeremy Handel, "Cash No Longer King," *ACA News* (February 2000), pp. 32-33.

Actual performance is a function of worker effort, worker skill, and random effects. The random effects include performance measurement error, problems or inefficiencies created by coworkers or adjacent workstations, illness, and weather-related production problems. After the actual performance is measured, determining the contributions of the controllable and noncontrollable factors to the achieved performance is impossible in many instances. Consequently, workers bear the risk of outcome effects of both types of factors. Thus, using performance-based pay systems causes workers to bear more risk than when less comprehensive input-output measurements are used to determine compensation. Efforts should be made to identify performance measures that minimize the risk borne by workers.

At the worker level, performance measures should be specific and typically have a short-run focus—usually on cost and/or quality control. Each higher level in the organizational hierarchy should include increasingly more elements related to the critical success factors under an individual's control and responsibility. Performance measures should, by necessity, become less specific, focus on a longer time horizon, and be more concerned with organizational longevity rather than short-run cost control or income.

Once the operational targets, compensation strategy, and performance measurements are determined, appropriate target rewards can be specified. These rewards should motivate individual employees to contribute in a manner congruent with the operational objectives, and employees must be able to relate their performance to the reward structure.

Incentives Relative to Organizational Level

As with performance measures, an employee's organizational level and current compensation should affect the types of rewards chosen. Individuals at different organizational levels typically view monetary rewards differently because of the relationship of pay to standard of living. Relative pay scales are essential to recognizing the value of monetary rewards to different employees. At lower employee levels, more incentives should be monetary and short term; at higher levels, more incentives should be nonmonetary and long term. The system should, though, include some nonmonetary and long-term incentives for lower-level employees and some monetary and short-term incentives for top management. Such a two-faceted compensation system provides lower-paid people with tangible rewards (more money) that directly enhance their lifestyles, but also provides rewards (such as stock options) that cause them to take a long-run "ownership" view of the organization. In turn, top managers, who are well paid by most standards, should receive more rewards (such as stock and stock options) that cause them to be more concerned about the organization's long-term well-being rather than short-term personal gains.

Performance Plans and Feedback

As employees perform their required tasks, performance related to the measurement standards is monitored. The two feedback loops in the model shown in Exhibit 21-1 exist so that any problems identified in one period can be corrected in future periods. The first feedback loop relates to the monitoring and measurement of performance, which must be considered in setting targets for the following periods. The second feedback loop relates to the rewards given and the compensation strategy's effectiveness. Both loops are essential in the managerial planning process.

Just as there are numerous ways to tie organizational performance to employee rewards, there is also a wide variety of reward plans available to organizations. The major types of compensatory arrangements in use for workers and managers are discussed next.

Worker Compensation

In addition to the recent changes in competitive focus, organizational culture, local laws, union affiliation, and political considerations will affect the choice of pay plan. For example, although the piece rate pay plan may work effectively for some U.S. businesses, such a compensation plan may not work at all in a Japanese plant. The Japanese workforce is more attuned to the group and organization than to the individual. A plan that determines worker compensation based on individual performance would clash with the Japanese culture. Also, installing a performance-based pay plan in any firm can be difficult if the plan's objectives are not clearly specified or if the organizational culture is not suited to such a plan. Even differences in labor laws among countries can affect pay plans. Exhibit 21-4 indicates how stock-based plans would have been received in various countries several years ago. As indicated in the News Note on page 932, however, the same reactions may no longer occur.

periodic compensation

The most basic of all reward plans consists of hourly, weekly, monthly, or other **periodic compensation**, which is based on time spent at work rather than on tasks accomplished. Different workers command different periodic pay rates/amounts because of seniority, skill, or education level. However, this type of compensation provides no immediate link between performance and reward. The only motivational aspects of periodic compensation are the prospects for advancement to a higher periodic pay rate/amount, demotion to a lower pay rate/amount, or dismissal. Because this pay plan provides little incentive to achieve, worker performance is monitored by superiors rather than tracked by financial records. Organizational performance is ensured through monitoring and instruction instead of the motivation of the performance/reward relationship.

Worker Pay and Performance Links

The competitive environment in many industries has undergone substantial changes that have, among other effects, led to companies using greater automation and fewer labor-intensive technologies. Also, evolving management philosophies are

EXHIBIT 21-4

Thinking about a Stock-Based Compensation Plan in that Foreign Sub?

Below are predicted reactions to the installation of a stock-based compensation plan in various parts of the world as of 1995:

Belgium Problematic. Some stock plans conflict with a government-imposed wage freeze.

Brazil Impossible. Foreign-exchange controls prohibit out-of-country stock investment, phantom stock plans are a headache.

Britain Easy. But sometimes labor unions can get in the way.

Eastern Europe Forget it. Even if you get government permission, chances are you've talked to the wrong bureaucrat.

Germany Can I get that in deutsche marks? U.S. plans suffer when the dollar is weak.

Israel Difficult. Exchange controls forced National Semiconductor to a third-party system, but plan has only scant participation.

Luxembourg Tax haven. Great place to set up a trust to administer stock plans.

Mexico May regret it. Labor laws can force a one-time stock grant into an annual event.

Netherlands No thanks. Employees may like the stock options, but they won't appreciate a hefty tax bill upfront.

Philippines Time-consuming. Requires government approval and lots of worker education.

SOURCE: Tara Parker-Pope, "Culture Clash: Do U.S.-Style Stock Compensation Plans Make Sense in Other Countries?" *The Wall Street Journal* (April 13, 1995), p. R7. Reprinted by permission of *The Wall Street Journal*, © 1995 Dow Jones & Company, Inc. All rights reserved worldwide. Permission conveyed through the Copyright Clearance Center.

now emphasizing the need for workers to perform in teams and groups. An interesting paradox has been created by these changes. Workers are more detached from the production function and more involved with higher technology tasks, so it is more difficult to control workers through direct oversight and supervision. These changes require firms to rely more on results-based evaluations even though identifying appropriate performance evaluation criteria is now more difficult because of the more indirect worker/production relationship. Nevertheless, the trend is to rely more on performance-based evaluation and less on direct supervision to control worker behavior. This trend is consistent with the movement to empower workers and decrease levels of supervision and layers of management.

One common performance-based pay plan is **merit pay**, in which a pay increment is earned after achieving a specific performance level. Although merit pay typically represents a raise in the base pay that continues throughout the worker's tenure with the firm, some merit pay may expire at a future date or be made contingent on a continuing high level of performance.

A variety of other performance-based pay plans exists. For some workers, the basic wage may be partly replaced with a contingent pay plan. **Contingent pay** is not guaranteed like the basic wage, but is dependent on the achievement of some performance objective. The contingent pay plan adds a pay-for-performance dimension to the compensation package. The contingent pay can be a fixed amount or may vary with, for example, the level of achieved sales or profit. It can be paid in cash, stock, or another form. Also, the plan can be structured to apply to group or individual performance.

At the extreme end of the performance-based pay incentive plans are **piece rate** payment arrangements wherein workers are paid a flat rate for each unit of work accomplished. Some alternatives may combine the piece rate with a basic hourly rate to guarantee workers a minimal return on their time and effort. Such combination-type piece rate plans serve to protect workers from poor judgments or errors in setting piece rates.

Promoting Overall Success

A significant problem with piece rate payment plans is their failure to provide incentives for workers to consider overall organizational success. Alternative performance-based plans exist for this purpose, many of which have the expressed goal of getting common stock into the hands of employees. One popular arrangement is profit sharing, which provides incentive payments to employees. These current and/or deferred incentive payments are contingent on organizational performance and may be in the form of cash or stock. Allocation of the total profit-sharing payment among individual employees is made on the basis of personal performance measurements, seniority, team performance, managerial judgment, or specified formulas.

In addition to profit-sharing arrangements, some firms pay employees a portion of their compensation in stock options or stock appreciation rights. **Stock options** allow the holder to purchase shares of company common stock at specified terms. These terms usually relate to price and designate the future time frame during which the stock may be purchased. **Stock appreciation rights** allow employees to receive cash, stock, or a combination of cash and stock based on the difference between a specified amount per share of stock and the quoted market price per share at some future date. In each situation, the amount of compensation cannot be determined with certainty at the date the incentive reward is received; instead, the options or rights will become more valuable if the price of the common stock rises.

Another popular profit-sharing compensation program is the **Employee Stock Ownership Plan (ESOP)**, in which investments are made in the securities of the employer. An ESOP must conform to rules in the *Internal Revenue Code*, but offers both tax and incentive advantages. Under an ESOP arrangement, the employer

merit pay

contingent pay

piece rate pay

5

Why do many financial incentive programs involve shares of, or options for, common stock?

stock option

stock appreciation right

Employee Stock Ownership Plan (ESOP)

makes tax-deductible payments of cash or stock to a trust fund. If cash is contributed, it is used by the trust to purchase shares of the employing company's stock. The trust beneficiaries are the employees, and their wealth grows with both the employer contributions and advances in the price of the stock.

Nonfinancial Incentives

Besides various forms of monetary compensation, workers may also be motivated by nonfinancial factors. Although all employees value and require money to satisfy basic human needs, other human needs cannot necessarily be fulfilled with monetary wealth. Employees desire some compensation that satisfies their higher order social needs. For example, workers and managers will typically be more productive in environments in which they think their efforts are appreciated. Simple gestures such as compliments and small awards can be used by superiors to formally recognize contributions of subordinates. Allowing subordinates to participate in decisions affecting their own welfare and the welfare of the firm also contributes to making employment socially fulfilling. Such efforts provide assurance to employees that they are serving productive roles in the firm and that superiors are attentive to, and appreciative of, employee contributions.

MANAGERIAL COMPENSATION

6

Of what importance are nonmonetary rewards in motivating managers?

Managers are primary decision makers in organizations and are subject to less direct supervision than workers. They are more likely than workers to be evaluated and compensated based on the results achieved and the contributions made toward achieving the organization's strategic objectives. Frequently, top-level managerial compensation is directly linked to company stock price and/or to corporate earnings performance. Bonuses based on organizational performance comprise a significant portion of the income of chief executive officers in most U.S. industries.

Prior chapters discuss various incentive-compatible ways to evaluate managerial performance. For example, Chapter 19 indicates that residual income, economic value added, and return on investment are three useful financial performance measures for managers of decentralized operations. Other chapters discuss the roles of standard costing, variance analysis, and budget-to-actual comparisons in performance evaluation. Chapter 20 discusses a variety of nonfinancial indicators used as bases to assess the efficiency and effectiveness of managerial efforts. Managers will find improving these performance measures to be much more important when the reward structure is directly linked to them. "When many things are measured but only financial results are rewarded, it is obvious which measures will be regarded as most important."³ Thus, the rewards to be provided in a performance-based compensation plan should be based on both monetary and nonmonetary, short-term and long-term measures. The mixture of monetary and long-term/short-term measures should be related to the organizational subunit's mission.

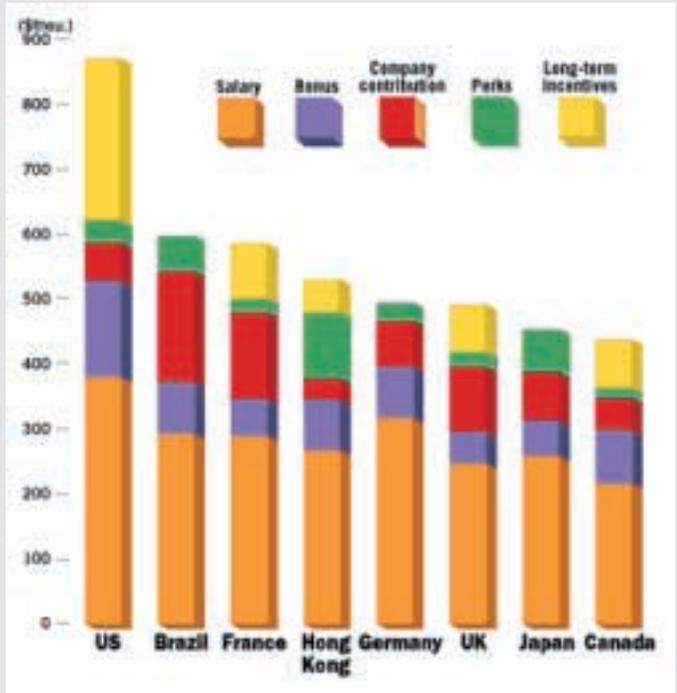
In addition to the monetary benefits, managers frequently are offered a variety of perquisites, or perks, for short. **Perks** are fringe benefits provided by the employer and include items such as vacations, free child care, free parking, personal assistants or private secretaries, health care, recreational club memberships, an office with a view, or flexible work hours. Exhibit 21-5 shows a mix of CEO compensation components from a sample of countries for a typical \$250 million industrial firm. Perks can be offered as an incidental benefit of the position or they can be offered as compensation for specific performance. Exhibit 21-6 indicates some popular perks that are offered to those same surveyed executives.

perks

³ Robert G. Eccles and Philip J. Pyburn, "Creating a Comprehensive System to Measure Performance," *Management Accounting* (October 1992), p. 44.

EXHIBIT 21-5

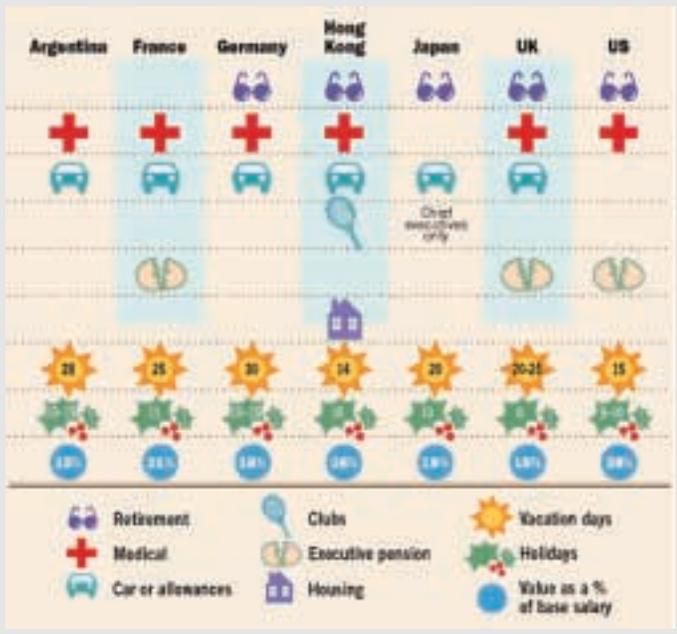
CEO Compensation Mix from around the Globe for \$250 Million Industrial Firm



SOURCE: Luisa Kroll, "Catching Up," *Forbes* (May 19, 1997), <http://www.forbes.com>. Reprinted by permission of Forbes Magazine. © Forbes, 1997.

EXHIBIT 21-6

Perks and Benefits from around the Globe



SOURCE: Luisa Kroll, "Catching Up," *Forbes* (May 19, 1997), <http://www.forbes.com>. Reprinted by permission of Forbes Magazine. © Forbes, 1997.

The pay and performance relationships discussed earlier are not equally applicable to all types of organizations. The discussion that follows addresses the unique aspects of not-for-profit and governmental organizations.

NOT-FOR-PROFIT AND GOVERNMENTAL COMPENSATION

The preceding discussion assumed that employee performance and rewards would be determined under the oversight of a self-interested group of stockholders who are concerned about the effectiveness and efficiency of operations. The stockholders assume this oversight role because they are the residual claimants who are entitled to be paid only after all other involved parties have received their compensation—be it wages, salaries, perks, or interest payments.

Not-for-profit and governmental organizations have no direct counterpart to stockholders. No single self-interest group has the financial incentive to seek assurances that employees and managers perform their work effectively and efficiently. This one distinct factor may partially account for the horror stories, detailing out-of-control purchasing practices in the Pentagon or other governmental units, that occasionally appear in the press. Although some link exists between pay and performance in not-for-profit and governmental agencies, this relationship is typically not as direct or as strong as that existing in private companies.

The historical norm for public and not-for-profit organizations is time-based pay plans. The use of such plans has several nonperformance advantages, including the ease of predicting and budgeting costs and the avoidance of pay disputes. But as far back as 1988, employees were expressing substantial dissatisfaction with the performance evaluation and reward system in the federal government. “A poll of some 4,000 federal workers indicated that 70% of the workers regarded the pay as unfair, 74% felt that the bonus and merit pay systems were unfair, and a whopping 90% supported innovation in pay plans that would more closely link pay and performance.”⁴ Such complaints are not unusual in many governmental and not-for-profit entities. The trend in these organizations has been to try to tighten the linkage between pay and performance so that the best and brightest employees do not leave the public sector.

Several experiments are ongoing, particularly in federal government, to attract and retain the most qualified employees. The financial and nonfinancial incentives for producing quality products and services that are becoming an essential part of private industry compensation plans are also being considered for adoption in public-sector and not-for-profit agencies. However, according to a survey in the 1990s by PricewaterhouseCoopers, LLP, only 20 percent of not-for-profit entities provided bonus plans for their top executives.⁵

Whether employees work in the private sector, not-for-profits, or the government, the effects of income taxation should be considered when the compensation system is designed. The following section indicates that fringe benefits and certain other forms of compensation may be preferred to cash compensation because of the relative tax benefits.

TAX IMPLICATIONS OF COMPENSATION ELEMENTS

7

How do taxes affect the design of compensation plans?

In recent years, individual tax rates have been as high as 50 percent and corporate tax rates have been as high as 46 percent of taxable income. Currently, tax rates for individuals and corporations are well below these levels. But because current tax rates are still significant, one important consideration is the tax consequences of the alternative rewards provided by compensation packages. Differences in tax treatments are important because of the effect on the after-tax income received by

⁴ Albert C. Hyde, “The New Environment for Compensation and Performance Evaluation in the Public Sector,” *Public Personnel Management* (Winter 1988), pp. 351–358.

⁵ From the no longer existing Coopers & Lybrand home page, Web site.

the employee and the after-tax cost of the pay plan to the employer. There are three different tax treatments for employee compensation: full and immediate taxation, deferral of taxation, and exemption from taxation.⁶ **Tax deferral** indicates that taxation occurs at a future, rather than current, date. **Tax exemption** is the most desirable form of tax treatment because the amount is never subject to income taxation. Tax rates vary greatly around the world among cities, states, and countries. Exhibit 21-7 illustrates tax rates and the amount of after-tax compensation realized by an executive earning \$650,000 in various cities in the late 1990s.

In the United States, most forms of compensation are fully and currently taxable to the employee and fully and currently deductible by the employer. For instance, wages represent income that is taxable to the employee when earned and tax deductible to the employer when incurred. The special, favorable tax treatments of deferral and exemption are provided under the tax code to encourage certain socially desirable behavior on the part of employers and employees.

For two reasons, the discussion of the tax aspects of compensation must center on the federal income tax and its effect on the employer and employee. First, although other taxes (such as payroll taxes, state income taxes, and unemployment taxes) may be affected differently by choices in reward structures, the impact of such taxes is rather minimal relative to the corporate and individual federal income taxes. Second, the impact of state income tax will vary from state to state and, thus, is beyond the scope of this text.

Fringe Benefits

When analyzing the compensation plan, employers and employees must consider the entire package—not simply one element of the package. For the employer, compensation above wages and salaries will create additional costs; for employees, such compensation creates additional benefits. Fringe benefits may include employee health insurance, child care, physical fitness facilities, and pension plans. However, different types of fringe benefits have different tax consequences.

Certain employee fringe benefits are not treated as taxable income to the employee, but are fully and currently deductible by the employer. One important type of these fringe benefits is employer-provided accident and health insurance plans. Premiums on such plans can be deducted for tax purposes when paid by the

tax deferral
tax exemption

City	Effective Tax Rate	After-Tax Amount Realized from \$650,000 Pretax Income
Dubai	0%	\$650,000
Hong Kong	11.24%	576,937
Singapore	22.26%	505,306
Sao Paulo	22.90%	501,163
Bombay	26.02%	480,852
Mexico City	26.28%	479,169
Seattle	32.21%	440,624
Moscow	33.94%	429,382
Zurich	37.06%	409,118
London	38.13%	402,168
New York	38.77%	397,982
Milan	40.20%	388,693
Tokyo	45.94%	351,380
Brussels	48.32%	335,889

SOURCE: Alexandra Kirkman, "A Taxing Question," *Forbes* (May 18, 1998), <http://www.forbes.com>. Reprinted by permission of Forbes Global Business & Finance Magazine. © Forbes Global Inc., 1998.

EXHIBIT 21-7

*Compensation and Global
Taxation*

⁶ Myron S. Scholes and Mark A. Wolfson, *Taxes and Business Strategy: A Planning Approach* (Englewood Cliffs, N.J.: Prentice Hall, 1992), p. 33.

employer, but the premium is not treated as taxable income to the employee. If each employee purchased the insurance individually, there might also be certain tax benefits. However, the tax treatment available when employees spend after-tax earnings for the services is not as preferable as the full exemption from taxation that occurs in an employer-provided plan.

The importance of various fringe benefits is directly related to an individual employee's needs and wants, which is why some companies have instituted flexible fringe benefit programs called **cafeteria plans**. These plans contain a "menu" of fringe benefit options including cash compensation and nontaxable benefits alternatives. If the employee elects to receive cash in lieu of nontaxable fringe benefits, the cash is fully taxable. However, employees who elect fringe benefits such as health care, group term life insurance, or child care receive these benefits free of tax. Flexibility is the greatest benefit of cafeteria plans because employees, based on their perceptions of the benefits' values, choose which benefits to receive.

cafeteria plan

Deferred Compensation

Various forms of deferred compensation were identified earlier in this discussion. **Deferred compensation** represents pay related to current performance that will be received at a later point in time, typically after retirement. Among the diverse types of deferred compensation plans are profit-sharing arrangements, pensions, and various stock-based plans (including the ESOP). Many of these plans receive substantially identical treatment under the tax rules. The employer is allowed a current deduction for payments made to the plan, but the employee is not taxed until distributions are received from the plan. This treatment creates two significant tax benefits. First, no immediate taxable income is created for the employee by the employer's contribution. Second, no taxation of earnings on the plan occurs between the year of contribution and the year of distribution. In short, the employer's contributions and the earnings on the contributions are accorded tax-deferred treatment. When the employee reaches retirement and receives payments from the plan, all receipts are wholly taxable. However, the employee is frequently in a lower tax bracket at that time and will have enjoyed tax-free growth in the contributions over his or her working career.

deferred compensation

Although the tax treatment to the employee of the various types of deferred compensation may not be significantly different, substantial differences exist in incentive effects. For example, the growth in the value of a pension plan may be largely unrelated to the employing corporation's stock performance. However, reward plans involving the employing company's stock have both a compensatory and an incentive element. Growth in the value of the deferred compensation depends on both the current contribution amounts and the change in the stock's value. Hence, employees are motivated to be concerned with stock performance—which is partly determined by corporate earnings. Exhibit 21–8 provides a summary of the pay elements and their relationships to the various concepts discussed in the chapter.

Because the self-serving motives of managers, workers, and stockholders frequently diverge, a proper reward structure needs to balance the interests of the three groups. Each group is entitled to an adequate return for the risks it bears and contributions it makes to the organization's success. Inevitably, ethical dilemmas will be encountered when opportunities arise for one of the three groups to gain advantage over one or both of the other groups.

ETHICAL CONSIDERATIONS OF COMPENSATION

8

Why should ethics be considered in designing a compensation package?

A phenomenon that has accompanied corporate growth is the emergence of professional managers and the dispersion of organizational ownership. In the largest corporations, no individual or group may own a large enough portion of common stock to directly influence the efforts and decisions of professional managers. This

	Link to Performance	Tied to Company Objectives	Promotes Quality	Level of Motivation	Time Focus	Taxable to Employee*	Deductible by Employer*
Hourly Wages/ Monthly Salary	Little	No	No	Low	Short term	Currently	Currently
Merit Pay	Some	Possibly	Possibly	Medium	Short term	Currently	Currently
Contingent Pay	High	Possibly	Possibly	Medium	Short term	Currently	Currently
Piece Rate	High	Possibly	No	High	Short term	Currently	Currently
Profit Sharing	Some	Yes	Yes	Medium	Depends	Depends	Currently
Stock Options/ Appreciation Rights	High	Yes	Yes	Medium	Long term	Deferred	Depends
ESOPs	High	Yes	Yes	Medium	Long term	Deferred	Currently
Perks	Some	Possibly	Possibly	Medium	Short term	Depends	Currently
Health Insurance	Little	No	No	Low	Short term	Exempt	Currently
Cafeteria Plan	Little	Possibly	Possibly	Medium	Depends	Depends	Currently
Pensions	Some	Possibly	Possibly	Medium	Depends	Deferred	Currently

*Subject to proper compliance and to potential regulatory changes.

EXHIBIT 21-8

Summary of Pay Plans

circumstance gives top managers greater discretion in operating the business and may also allow them to feel insulated from stockholders and their desires. Some observers argue that this atmosphere of discretion and insulation may be used to the managers' benefit rather than to the stockholders'. A number of ethical issues need to be resolved in this new millennium with regard to organizational governance and compensation of workers and managers.

Organizational Governance

Some argue that laws protecting the rights of stockholders failed to evolve with the dispersion of corporate ownership in the United States. Further, stockholder interests have become more diverse as institutional traders (such as pension funds) have moved into the capital markets along with individuals and industrial firms. Institutions have historically been passive investors and have not been diligent in voting their shares or monitoring managerial performance. Thus, professional managers have become less sensitive to stockholder concerns and have occasionally forgotten a manager's primary duty is to act in good faith for the organization.

Role of Capital Markets

Under these circumstances, the capital markets have assumed an important role in ensuring that management teams are disciplined in their use of corporate resources.

takeover

For example, partly as a response to ineffective, entrenched management groups, the 1970s and 1980s were witness to many attempted and successful hostile takeovers. In a **takeover**, an outside or inside investor acquires managerial control of a corporation by acquiring enough common stock and stockholder votes to control the board of directors, and thereby control management. The adjective *hostile* (as opposed to *friendly*) indicates that the takeover is not welcomed by management and frequently indicates that one objective of the takeover is to replace management.

raider

Raider is a pejorative term used to describe a firm or individual who specializes in hostile takeovers. Raiders commonly identify firms as takeover targets when those firms are believed to be undervalued because managers are not acting in the stockholders' best interests. For example, managers of some conglomerates could increase stockholder value by selling pieces of the conglomerate that are not synergistic with other pieces.

Takeovers can have either positive or negative effects on existing shareholders and employees, depending on the acquiring firm's objectives and the actions taken by the management of the target firm. A takeover can represent an attempt to steal value from the existing managers and workers; alternatively, it can represent an effective mechanism to revitalize an organization plagued by ineffective management. In either case, managers have often been permitted to include certain elements in their compensation packages that allow a retention of power in the face of a hostile takeover.

golden parachute

One compensation device that has helped discourage takeover attempts and protect managers is the **golden parachute**, which is a benefits package payable to incumbent managers if those managers are terminated following a successful hostile takeover (or in some cases a friendly merger). Both the ethical and incentive effects of golden parachutes are difficult to assess. Some proponents argue that golden parachutes serve stockholder interests because "top managers are free to devote their attention to serving the interests of existing stockholders in the face of a takeover threat."⁷ These parachutes are viewed as providing managers with financial protection that will keep them unbiased in their actions, regardless of the outcome.

However, critics view the golden parachute as a means for entrenched managers to protect themselves in the event they are ousted. Proponents of this perspective are offended by the notion that managers who mismanage and create the conditions that originally attracted a takeover effort should profit by a takeover designed to remove those same managers for inept performance.

Golden parachutes also have taxation issues. When these devices were first introduced, corporations were allowed to deduct the payments as normal business expenses. Such deductibility was affected significantly by the 1984 Deficit Reduction Act, which added a 20 percent excise tax on amounts received by an executive that are in excess of three times a five-year average salary. Although many companies have agreed to pay this tax as part of a manager's severance package, a corporate deduction is disallowed for the excess payment.

Compensation Differentials

A major issue of discussion and contention involves perceptions of disparity between the pay of ordinary workers and top managers. Plato argued that no one should earn more than five times the income earned by the lowest-paid worker. In the early 1900s, however, J. P. Morgan stated that the differential should be no more than 20 times. Today, there are numerous examples of CEOs earning many times the pay of the average worker. The accompanying News Note provides more information on the contrast between upper-management earnings and the pay realized by lower-level workers.

<http://www.dismal.com>
<http://www.continental.com>

⁷ Bob L. Sellers, "Bankers Discover the Golden Parachute," *Bankers Monthly* (June 1988), p. 54.

ETHICS



NEWS NOTE

What Would Plato Think?

Everyone knows that Internet entrepreneurs and Wall Street wizards have seen their salaries zoom during the current economic expansion. But what about everybody else?

The answer isn't very encouraging. According to data prepared by Dismal Sciences, an economic consulting firm in West Chester, Penn., workers in many occupations have seen wage and salary gains so small since the economic expansion began in 1991 that they just barely kept up with inflation.

Out of 129 common occupations tracked by Dismal Sciences, which uses data provided by the Labor Department, 24 saw wage declines after adjusting for inflation. Dismal Sciences figures that inflation, as measured by the consumer price index, rose 22.3% between 1991 and 1999. So workers whose salaries rose less than that amount lost ground.

But the story isn't as simple as widely assumed. Yes, wages for low-skilled workers in service industries, including cashiers and restaurant workers, languished. Average wages for hotel desk clerks were \$15,520 in 1999, down about 3.6% from \$16,100 in 1991 before adjusting for inflation.

But some high-skilled workers lost out, too. Consider airline pilots. Their salaries remain high relative to other professional workers, but average wages for the group declined to \$78,880 in 1999 from \$79,900 in 1991. "We've been playing catch-up ever since" corporate restructurings in the 1980s and early 1990s drove pilots' wages down 38%, says James Moody, a spokesman for the Independent Association of Continental Pilots, a union for Continental Airline's pilots. More recently "we've caught up," he adds, noting pilots recently agreed to a contract that significantly boosted salaries.

The boom hasn't been particularly kind to government employees, who until recently have been held back by fiscally conservative state and local governments. Law-enforcement professionals' wages grew at about the rate of inflation, 22.5%, to \$37,540, and firefighters were barely better, notching a 22.8% increase to \$36,980.

SOURCE: Adapted from Patrick Barta, "The Longest Boom/The American Worker: Rises in Many Salaries Barely Keep Pace with Inflation—Data Show Some Wages Have Even Fallen Despite Economic Boom," *The Wall Street Journal* (February 1, 2000), p. A2.

A new, major conflict between workers and managers surfaced in the 1990s. As more bonus plans of upper managers were revised to make them more sensitive to stockholder issues, top managers became more aggressive in controlling costs to generate profits. Simultaneously, technological advantages allowed firms to increase their productivity; that is, generate more output using fewer workers. These two forces combined to create an historically rare circumstance: firms reporting record levels of profits while they concurrently fired hundreds or thousands of workers. Thus, as top executives were receiving record levels of pay, many average workers were losing their jobs. The salary differentials between workers and CEOs are often created by a type of self-fulfilling prophecy caused by the board of directors. Although it is the job of the board of directors to protect the interests of stockholders, the composition of boards is usually split between outsiders and insiders. Insider directors may be officers of the corporation and naturally identify more with the management group than the owners. Accordingly, these directors are sympathetic with the manager's position in stockholder/manager conflicts.

Oftentimes, a company's board of directors will survey a group of similar organizations to determine the "average" compensation for an executive. If the company's executive appears to be underpaid, the board will increase his or her compensation. Therefore, the next time the survey is performed, the average will have been increased—regardless of managerial performance. Such indiscreet consumption of organizational resources can cause common stock prices to decline and can undermine the stockholder value maximization goal.

Thus, the greatest ethical dilemmas involve circumstances that pit the welfare of employees against those of stockholders or the welfare of managers against the

welfare of workers. Only if there is a perception of equity across the contributions and entitlements of labor, management, and capital will the organization be capable of achieving the efficiency to compete in global markets.

GLOBAL COMPENSATION

9

What concerns need to be addressed in developing compensation packages for expatriates?

expatriate

As more companies engage in multinational operations, compensation systems must be developed that compensate expatriate employees and managers on a fair and equitable basis. **Expatriates** are parent-company and third-country nationals assigned to a foreign subsidiary or foreign nationals assigned to the parent company. Relocating individuals in foreign countries requires consideration of compensation. A fair and reasonable compensation package in one locale may not be fair and reasonable in another. An early 1990s survey of 45 multinationals indicated that every respondent considered differing pay levels, benefits, and perks as one of the biggest problems in developing an international workforce.⁸

The compensation package paid to expatriates must reflect labor market factors, cost-of-living considerations, and currency fluctuations as well as give recognition to tax consequences. Typically, an expatriate's base salary and fringe benefits should reflect what he or she would have been paid domestically. This base should then be adjusted for reasonable cost-of-living factors. These factors could be quite apparent (such as obtaining housing, education, and security needs similar to those that would have been obtained in the home country or compensating for a spouse's loss of employment) or they could be less obvious (such as a need to hire someone in the home country to care for an elderly relative or to handle real estate investments).

Because expatriates have a variety of monetary needs, these individuals may be paid in the currency of the country in which they reside or in their home currency or a combination of both. Frequently, price-level adjustment clauses will be built into the compensation system to counteract any local currency inflation or deflation. But, regardless of the currency makeup of the pay package, the fringe benefits related to retirement must be related to the home country and should be paid in that currency.

Exhibit 21-9 provides a recent summary of flexible benefits provided by European companies to their expatriates. These data were obtained from a survey of more than 270 of Europe's leading business organizations.

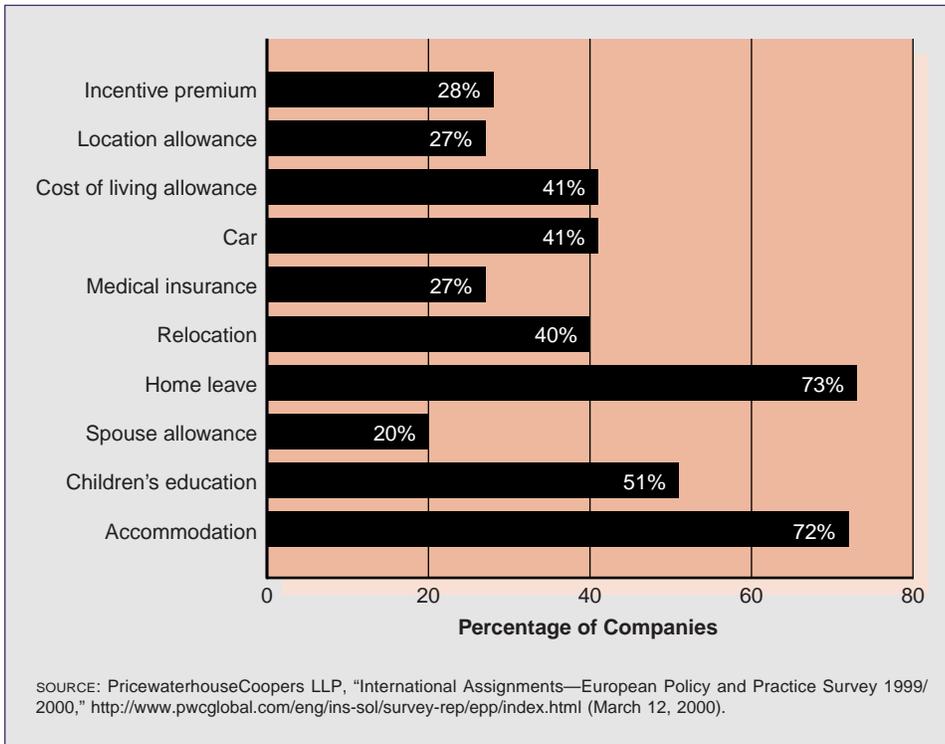
Income taxes are important in the compensation package of expatriates because they may pay taxes in the local country, home country, or both. Some countries (such as the United States and Great Britain) exempt expatriates from taxation on a specified amount of income earned in a foreign country. If a tax treaty exists and local taxes are paid on the balance of the nonexempt income of expatriates, such taxes may be credited against the expatriate's home nation income taxes. Regardless of how the package is ultimately determined, an ethical company will make certain that the system is as fair as possible to all employees involved and that it is cost beneficial and not an administrative nightmare.

Tying compensation to performance is essential because everyone in business recognizes that what gets measured and rewarded is what gets accomplished. Businesses must focus their reward structures to motivate employees to succeed at all activities that will create shareholder and personal value. In this highly competitive age, the new paradigm of success is to provide quality products and services at a reasonable price while generating a reasonable profit margin. Top management compensation has traditionally been tied to financial measures of performance; more and more companies are beginning to tie compensation to nonfinancial performance measures.

⁸ Organizational Resources Counselors Inc., "Global Headaches," cited in *The Wall Street Journal* (April 21, 1993), p. R5.

EXHIBIT 21-9

Benefits Provided by European Companies to Their Expatriates



REVISITING

Meridia Health System

<http://www.meridia.com>

Meridia implemented many changes to end its operating losses and achieve profitability. For example, the company placed a moratorium on physician recruitment and practice acquisitions. A practice management and billing system was acquired and implemented internally. In addition, the practice administrative staff was restructured and augmented, with the hospital system's human resource and accounting departments assuming expanded responsibilities for network operations. But, the biggest changes were made to the compensation model for physicians. The system established a budget reduction target for physician compensation of approximately \$500,000, roughly 14 percent of current compensation levels.

The system began by formally establishing a physician compensation task force composed of all its physician group presidents, additional physician representatives, and representatives from Meridia's practice management, human resource, and finance and accounting staffs.

[It was agreed that] compensation would vary from physician to physician and that receipt of historical compensation levels could not be guaranteed. Multilevel incentives were needed to demonstrate to the physicians that,

as employees, they are accountable not only for their individual activities but also for the effect of those activities on group and network results.

To determine physician compensation, the network reviews each physician's productivity during the most current 12-month period and determines the calculated [cash] collections he or she generated. From this amount, overhead is deducted to arrive at the physician's total budgeted salary. The physician then is paid 100 percent of this amount for the next six months. If, at the end of six months, the physician has fallen below his or her targeted productivity level, the physician's salary is adjusted downward to a maximum 35 percent reduction. If the physician's productivity level has been above the target, he or she receives a bonus. The bonus is put into escrow, if the physician wishes, to use to supplement his or her income should the physician's earnings decrease in the future.

Following approval of the plan, all physicians began to receive monthly reports that showed their current production and what their compensation would be under the new plan compared with their current salary. The group presidents were responsible for helping the physicians

interpret the results and develop strategies to achieve their compensation goals. Administration committed to providing accurate reports of practice results within three working days of the end of the month.

Results of the new compensation plan have been positive. In the first year, 25 physicians were compensated under the new plan: 13 of these physicians exceeded the budget target for their practices, generating \$400,000 over budget in revenues. Increases in practice productivity ranged from 10 to 25 percent. Patient encounters also increased by 6,000 visits among the 25 physicians on the plan.

Actual network overhead costs are shrinking, and the relationship between the physicians and administration

has improved. Physician participation in educational programs on topics such as billing, coding, chart documentation, clinical protocols, and utilization management has improved, and most importantly, practice patterns are changing for the better.

Meridia's compensation plan is not perfectly fair—no compensation plan ever will be. However, through good faith negotiations and compromise, Meridia and its primary care physicians were able to develop a workable compensation system that is helping both parties achieve their mutual goals of high-quality care, appropriate productivity, and operating efficiency.

SOURCE: Alexandra Davis and C. Thompson Hardy, "New Compensation Model Improves Physician Productivity," *Journal of the Healthcare Financial Management Association* (July 1999), pp. 46–49.

CHAPTER SUMMARY

In American industry, corporate stockholders play a unique role. Stockholders do not receive benefit from their investments until all other parties have been paid for their contributions. For bearing this risk, stockholders have the right to establish the contributions to be made and rewards to be received by the corporation's employees.

Although maximizing stockholder value is the maintained objective of profit-oriented corporations, employees are not naturally concerned with stockholder welfare. Thus, incentives must be provided to employees to motivate them to maximize their own wealth while concurrently maximizing that of the stockholders.

In the past, compensation was often based solely on individual performance and short-run, financial results. Because of operational changes and shifts in managerial philosophies, performance measurements and their related rewards now encompass group success, nonfinancial performance attributes, and long-run considerations. Some of the rewards provide short-run satisfaction (merit pay and bonuses), whereas others provide long-run satisfaction (common stock ownership).

Pay plans are available that involve current compensation, deferred compensation, and perks. Three important dimensions of pay plans are incentive effects, tax effects, and ethical considerations. Incentive effects vary from plan to plan. The periodic pay plan is the least effective in directly motivating employees to perform and provides the weakest link between performance and reward. At the other extreme, the piece rate pay plan provides a direct link between the work accomplished and the employee reward, as long as it promotes quality and group cooperation.

Not-for-profit and governmental entity employees have historically been dissatisfied with their compensation plans. Some of these organizations are now attempting to strengthen the association between compensation and performance to encourage retention of high-quality employees in public-sector careers.

Tax benefits vary among reward structure types. For the employee, rewards may be fully and currently taxable, tax deferred, or tax exempt. Although regular pay is generally fully and currently taxable, certain employer-provided fringe benefits are tax exempt to employees while providing current deductions for employers. Additionally, some elements of incentive compensation plans can be structured to defer taxation.

In designing reward structures, consideration should be given to ethical questions. Three changes that have influenced the power structure in the corporate world are the rise of professional managers, dispersion of stock ownership, and extensive involvement of institutional investors in capital markets. Additionally, some top managers' compensation grossly exceeds pay to ordinary workers. Such excesses can be counterproductive, causing a demoralizing effect within the firm and, ultimately, the failure to succeed in maximizing long-term stockholder wealth. Additional stress between management and workers is being created by employee layoffs that are driven by management's pursuit of higher profits. These situations create ethical issues that should be considered when establishing a compensation strategy that will ensure fairness, effectiveness, and efficiency in an organization.

KEY TERMS

cafeteria plan (p. 944)	periodic compensation (p. 938)
compensation committee (p. 930)	perks (p. 940)
compensation strategy (p. 930)	piece rate pay (p. 939)
contingent pay (p. 939)	raider (p. 946)
deferred compensation (p. 944)	shirking (p. 935)
Employee Stock Ownership Plan (ESOP) (p. 939)	stock appreciation right (p. 939)
expatriate (p. 948)	stock option (p. 939)
financial incentive (p. 930)	takeover (p. 946)
golden parachute (p. 946)	tax deferral (p. 943)
merit pay (p. 939)	tax exemption (p. 943)

SOLUTION STRATEGIES

The design of an effective reward structure depends heavily on each organization's unique characteristics. It is impossible to design a generic incentive model that would be effective in a variety of firms. However, affirmative answers to the following questions provide guidance as to the applicability of a proposed incentive and reward plan for a particular organization.

1. Will the organizational objectives be achieved if the proposed compensation structure is implemented?
2. Is the proposed structure consistent with organizational design and culture, and management philosophy?
3. Are there reasonable and objective performance measures that are good surrogates for the organizational objectives and subunit missions?
4. Are factors beyond employee/group control minimized under the performance measures of the proposed compensation structure?
5. Is there minimal ability of employees to manipulate the performance measurements tied to the proposed compensation structure?
6. In the light of the interests of managers, workers, and stockholders, is the proposed reward structure fair and does it encourage and promote ethical behavior?
7. Is the proposed reward structure arranged to take advantage of potential employee/employer tax benefits?
8. Does the proposed reward structure promote harmony among employee groups?
9. Is there an adequate balance between group and individual incentives?

QUESTIONS

1. How are organizational strategies linked to managerial reward structures?
2. Why would an effective compensation strategy treat top managers, middle managers, and other workers differently?
3. The trend in American business is away from automatic pay increases and toward increased use of incentive compensation plans. Why has this trend developed?
4. If worker performance measures used in a pay-for-performance plan are not highly correlated with corporate goals, what is the likely result for the organization? For the workers?
5. How does the time perspective of a performance-based plan affect the selection of performance measures?
6. Why should different missions for two subunits result in different performance reward structures for the managers of the two subunits?
7. Why should worker age be taken into account when designing performance-based pay systems?
8. If a firm offers substantial group-level performance incentives, but no individual performance incentives, how might workers respond?
9. Why are performance-based worker evaluations riskier for workers than evaluations based on direct observation by superiors?
10. Why are additional performance measurement and reward issues created when managers are not shareholders in the firms they manage?
11. How do performance-based rewards create risk for the managers and employees who are so evaluated?
12. How is feedback used in a performance-based reward system?
13. Identify the more important differences between periodic compensation and contingent compensation. Why do you believe these to be important?
14. Why is piece rate pay the extreme form of a performance-based pay system?
15. Many pay structures involve both cash compensation and stock-based compensation. Why do firms want employees to be holders of the firm's common stock?
16. How is the mix of financial and nonfinancial, and short-term and long-term, rewards affected by the mission of an organizational subunit?
17. What are perks? What are the advantages associated with the use of perks in rewarding performance?
18. Why must reward structures in not-for-profit and governmental organizations be structured differently than those for profit-oriented firms?
19. Why must income taxation be taken into account in designing a reward system? What are the alternative tax treatments of the various compensation alternatives?
20. Why is flexibility the distinguishing characteristic of cafeteria plans? Why is flexibility important?
21. What are raiders? What positive and negative roles are served by raiders in capital markets?
22. What is a golden parachute? What are the alternative explanations for the existence of such plans?
23. What are some of the important equity issues in designing reward structures? Why is the achievement of equity in the reward structure important?
24. For global enterprises, what are the additional concerns in designing a reward system, relative to single-country operations?

EXERCISES

- 25. (Terminology)** Match the following lettered terms on the left with the appropriate numbered descriptions on the right.
- | | |
|--|--|
| <ul style="list-style-type: none"> a. Cafeteria plan b. Compensation committee c. Deferred compensation d. Expatriate e. Piece rate pay f. Shirking g. Stock appreciation right h. Stock option i. Tax deferral j. Tax-exempt income | <ul style="list-style-type: none"> 1. A right for the holder to purchase common shares 2. A menu of fringe benefit options 3. Income that is taxed later rather than currently 4. Compensation contingent on increases in stock price 5. Free-riding 6. Income that is not subject to tax 7. Group that sets pay for CEO 8. Pay for current performance to be received in the future 9. A specific type of contingent pay plan 10. A foreign national assigned to the parent company |
|--|--|
- 26. (Characteristics of alternative pay plans)** For each of the following pay plan alternatives, indicate whether it provides a high (H) or low (L) level of motivation; whether the time focus is short term (S) or long term (LT); and whether there is a strong (ST), weak (W), or moderate (M) link with employee performance.
- a. Periodic pay plan
 - b. Cafeteria plan
 - c. Pension
 - d. ESOP
 - e. Profit sharing
 - f. Merit pay
 - g. Contingent pay
 - h. Piece rate pay
 - i. Stock option
 - j. Perks
- 27. (Pay plan and suboptimization)** Larry Smith is a division manager of Carroll Manufacturing Inc. Mr. Smith is presently evaluating a potential revenue-generating investment that has the following characteristics: An initial cost of \$1,000,000 and net annual increase in divisional income before consideration of depreciation:
- | | |
|--------|-----------|
| Year 1 | \$100,000 |
| Year 2 | 150,000 |
| Year 3 | 190,000 |
| Year 4 | 800,000 |
| Year 5 | 800,000 |
- The project would have a five-year life with no salvage value. All assets are depreciated according to the straight-line method. Mr. Smith is evaluated and compensated based on the amount of pretax profit his division generates. More precisely, he receives an annual salary of \$300,000 plus a bonus equal to 2 percent of divisional pretax profit. Before consideration of the above project, Mr. Smith anticipates that his division will generate \$2,000,000 in pretax profit.
- a. Compute the effect of the new investment on the level of divisional pretax profits for years 1 through 5.
 - b. Determine the effect of the new project on Mr. Smith's compensation for each of the five years.



(continued)

- c. Based on your computations in part (b), will Mr. Smith be hesitant to invest in the new project? Explain.
- d. Would upper management likely view the new investment favorably? Explain.



28. (*Internet exercise*) Executive Alliance is a firm that specializes in designing executive compensation services. Find the home page of this company and review the services it offers. Assume that you are on the board of directors of a midsize manufacturing company. Discuss how you might use the services of a firm such as Executive Alliance to develop your firm's compensation strategy.



29. (*Internet exercise*) National Center for Employee Ownership is a nonprofit organization that distributes information regarding employee ownership of businesses. Review the materials provided on the home page of this organization. Assume that you work for a company that is about to introduce an incentive stock option plan for its employees. Prepare a report in which you present to your company's top executives a strategy as to how materials from this organization could be used to introduce the idea of stock ownership to your employees.



30. (*Internet exercise*) Find the home page of Columbia/HCA Healthcare Corporation. This company is one of the United States' largest healthcare providers. Review the information provided by the company on its home page. Assume that you are a top executive of Columbia and that you have been charged with designing a compensation system for the doctors and nurses employed by the firm. Describe the major concerns that you would have in designing the compensation system and the major features you would incorporate in the compensation system.

31. (*Incentives and rewards*)

Why would anybody who runs a hot Internet start-up firm that's about to go public choose to get a fat salary, and not just wait for the usual stock windfall after the offering?

Why not, when you can get both?

To the consternation of many venture capitalists, potential investors and executive recruiters, that's exactly what has happened at Digital Entertainment Network Inc.

The company, one of the first pure-entertainment Internet start-ups that has filed for an initial public stock offering, has the Internet world buzzing about the huge, Hollywood-style salaries the company is paying to its top executives, alongside stock and options grants.

SOURCE: Peter Gumbel, "Deals & Deal Makers: Start-Up's High Salaries Raise Eyebrows—Internet Firm DEN's Pay Doesn't Follow Equity Path," *The Wall Street Journal* (Nov. 5, 1999), p. C1. Permission conveyed through the Copyright Clearance Center.

- a. As an investor in this start-up enterprise, how would you interpret the payment of a large salary in addition to stock and options to the top executives?
- b. What changes in compensation structure would you make in this firm if you were given the opportunity?



32. (*Pay plan, age, and suboptimization*) Big Green Inc. has operations in 13 states. Big Green is in the business of growing soybeans and processing the beans into two products: soybean oil and soybean meal. These products are then sold for various commercial uses. Operations in each state are under the control of an autonomous state manager whose performance is evaluated (in large part) based on the magnitude of annual profit. State managers typically receive an annual bonus equal to 1 percent of net state profits. The manager of North Carolina operations is Beano DuMars. Beano has just turned 63 years old and

<http://www.den.net>

has been with Big Green for 39 years. He would like to sell his existing bean crusher and purchase a new, technologically superior one. To evaluate the feasibility of such a move, Beano's controller prepared the information presented below. This information has created a tremendous dilemma for Beano.

Incremental cost of the new crusher	\$1,000,000
Expected remaining life of the old crusher	5 years
Expected life of the new crusher	5 years
Expected effect of the new crusher on net profit for the next 5 years:	
Year 1: Decrease in operating costs	\$ 300,000
Loss on disposal of old crusher	(750,000)
Net decrease in profit	\$ (450,000)
Year 2: Net increase in profit	200,000
Year 3: Net increase in profit	200,000
Year 4: Net increase in profit	255,000
Year 5: Net increase in profit	300,000

- a. Assume Beano expects to retire when he reaches age 65. Compute the effect of purchasing the new crusher on Beano's divisional profit and his compensation over his remaining career with Big Green.
 - b. If Beano had just turned 60 rather than 63, what would be the effect of purchasing the new crusher on Beano's compensation over his remaining career?
 - c. Is Beano's age likely to be an important factor in his decision regarding the purchase of the new crusher?
 - d. Would Beano's superiors prefer that he purchase the new crusher? Explain.
- 33. (Performance measurement)** You have just reviewed a proposal issued by the College of Business at your university. The proposal is about the methods to be used for evaluating the performance of, and rewarding of, professors. The principal provision of the proposal is to change the measures for evaluating performance of professors to emphasize achievements in research and professional service and to deemphasize teaching achievements. Another important provision is to more tightly link merit pay raises and promotion to the performance measurements.
- Assume you have been nominated to provide the student perspective in responding to this proposal. Prepare a report that will be presented to the college dean that summarizes your response.
- 34. (Suboptimization)** Compensation consultant Craig Schneier describes an experience by one of his clients who decided to pay the purchasing department employees bonuses if they kept the cost of purchases down:

The problem was, to make that happen they were relying on second-tier sources and accepting poor-quality materials. The company was in the middle of a very big order, and the fasteners were lousy and ended up costing millions of dollars, while the [purchasing] department walked away with big bonuses.

SOURCE: Adapted from Amanda Bennett, "Paying Workers to Meet Goals Spreads, But Gauging Performance Proves Tough," *The Wall Street Journal* (September 10, 1991), pp. B1, B4. Reprinted by permission of *The Wall Street Journal*, © 1991 Dow Jones & Company, Inc. All rights reserved worldwide.

- a. Using the plan–performance–reward model in Exhibit 21–1, identify where the company described above went awry in structuring the performance-based pay plan.
- b. How can the company use the feedback received regarding the purchasing department's performance to improve the design of the pay plan?
- c. How could the purchasing department's behavior be changed by combining the purchasing department with the production department for group-level performance evaluation purposes?

35. *(Variable pay and incentives)*

Salaries for CFOs of multi-billion dollar U.S. corporations rose 7% in 1999 to about \$466,000, but that figure was only 20% of their average overall compensation of \$2.37 million. The other 80% represented variable components—stock options (47%), annual incentives (17%), and long-term incentives (16%).

“CFOs hold a solid position among the ranks of executives rewarded more like owners than employees. The only other executives with a higher level of compensation at risk were CEOs, whose variable portion of pay amounted to 88%,” said Steven E. Hall, managing director of Pearl Meyer & Partners, executive compensation consultants.

SOURCE: Kathy Williams, “CFO, Controller Pay Is Up—With More at Risk,” *Strategic Finance* (February 2000), p. 23.

- a.** What does the high portion of variable CFO pay indicate about the importance of CFOs to their organizations?
- b.** Discuss any concerns investors might have about such a high percentage of CFO pay being variable.

36. *(Pay and incentives)* Global Oil Company is a multinational firm that markets a variety of chemicals for industrial uses. One of the many autonomous divisions is the North America Petro-Chemical Division (NAPCD). The manager of NAPCD, Carol Black, was recently overheard discussing a vexing problem with her controller, William Michaels. The topic of discussion was whether the division should replace its existing chemical-handling equipment with newer technology that is safer, more efficient, and cheaper to operate.

According to an analysis by Mr. Michaels, the cost savings over the life of the new technology would pay for the initial cost of the technology several times over. However, Ms. Black remained reluctant to invest. Her most fundamental concern involved the disposition of the old processing equipment. Because the existing equipment has been in use for only two years, it has a very high book value relative to its current market value. To illustrate, Ms. Black noted that if the new technology is not purchased, the division will earn a net income of \$8,000,000 for the year. However, if the new technology is purchased, the old equipment will have to be sold, and Ms. Black noted that the division can probably sell the equipment for \$2.4 million. This equipment has an original cost of \$16 million and \$3.0 million in depreciation has been recorded. Thus a book loss of \$10.6 million ($\$13\text{m} - \2.4m) would be recorded on the sale.

Ms. Black’s boss, Jim Heitz, is the president of the Western Chemical Group, and his compensation is based almost exclusively on the amount of ROI generated by his group, which includes NAPCD.

After thoroughly analyzing the facts, Ms. Black concluded, “The people in the Western Chemical Group will swallow their dentures if we book a \$10.6 million loss.”

- a.** Why is Ms. Black concerned about the book loss on disposal of the old technology in her division?
- b.** What are the weaknesses in the performance pay plan in place for Western Chemical Group that are apparently causing Ms. Black to avoid an investment that meets all of the normal criteria to be an acceptable investment (ignoring the ROI effect)?

37. *(Incentive compensation)*

General Motors Corp. earned record profit in 1995—but because results fell short of aggressive targets set by the board, bonus payouts to top GM executives were cut.

For John F. Smith Jr., GM’s chairman and chief executive officer, that meant a 9.2% reduction in salary and bonus to \$5.6 million from his 1994 total of \$6.1

million. The cut in compensation continues efforts by the GM board to hold management accountable for meeting financial-performance goals. Corporate governance experts observe that much of corporate America has been criticized for not tying executive compensation directly to company performance.

Unlike GM, Ford Motor Co. and Chrysler Corp. both reported earnings declines for 1995. They both cut executive bonuses accordingly.

SOURCE: Adapted from Rebecca Blumenstein, "GM Cuts Bonuses of Top Executives, Citing Unmet Goals Despite '95 Profit," *The Wall Street Journal* (April 10, 1996), p. A3.

Assume you are an advocate of John Smith Jr. Prepare a brief oral argument suggesting a reason or reasons why Mr. Smith should have been awarded a larger bonus.

<http://www.fordvehicles.com>

<http://www.chryslercorp.com>

38. (Performance measurement) In the mid-1990s:

Boston Scientific was giving Baxter International Inc. a run for its money. Boston Scientific, a small but growing maker of medical devices, didn't compete directly with health-care giant Baxter. But Baxter's top executives were keenly watching the performance of their new rival. Their compensation, in part, was based on it.

Baxter's payout of stock to its senior managers was linked to how the company's shares perform compared with the Standard & Poor's Medical Products and Supplies Index, which included the two companies plus seven others.

It was the latest twist in executive pay: awarding stock benefits according to how well a corporation stacked up against its rivals. Many comparisons, like Baxter's, are based on total shareholder return, though some used other measures such as return on assets. Whatever they used, the purpose was the same: to ensure that managers keep a gimlet eye on other companies competing for the same customer and investor dollars.

SOURCE: Adapted from Lauren Young, "Compare and Contrast: More Pay Plans Are Linked to How Well a Corporation Fares Against Its Rivals. The Problem: Finding an Appropriate Rival," *The Wall Street Journal* (April 11, 1996), p. R8.

Write a report in which you discuss the benefits and risks of evaluating and rewarding performance based on comparisons with competitors.

<http://www.bsci.com>

<http://www.baxter.com>

CASES

39. In the arena of worker compensation, there is no topic as hotly debated as the minimum wage law. In March 2000, the United States approved a \$1 an hour increase in the minimum wage, which would be phased in over two years. By 2002, the minimum wage would be \$6.15 per hour.

Two arguments advanced in favor of increasing the minimum wage were (1) that "the minimum wage has fallen sharply in real (inflation-adjusted) terms since 1991," and (2) "that raising the minimum wage actually reduced unemployment." However, virtually no facts exist to support the second argument and virtually all evidence suggests increases in the minimum wage cause loss of employment.

SOURCE: Bruce Bartlett, "Minimum Wage Hikes Help Politicians, Not the Poor," *The Wall Street Journal* (May 27, 1999), p. A26.

Using concepts from this chapter prepare a report in which you explain why increases in the minimum wage are not desirable and how alternative mechanisms could be used to increase the compensation of lower-paid workers.



40. (*Pay plans and goal congruence*) In 2000, the lead story in your college newspaper reports the details of the hiring of the new football coach. The old football coach was fired for failing to win games and attract fans. In his last season his record was 1 win and 11 losses. The news story states that the new coach's contract provides for a base salary of \$200,000 per year plus an annual bonus computed as follows:

Win less than 5 games	\$ 0
Win 5 to 7 games	25,000
Win 8 games or more	75,000
Win 8 games and conference championship	95,000
Win 8 games, win conference, get a bowl bid	150,000

The coach's contract has essentially no other features or clauses.

The first year after the new coach is hired, the football team wins 3 games and loses 8. The second year the team wins 6 games and loses 5. The third year the team wins 9 games, wins the conference championship, and is invited to a prestigious bowl. Shortly after the bowl game, articles appear on the front page of several national sports publications announcing your college's football program has been cited by the National Collegiate Athletic Association (NCAA) for nine major rule violations including cash payoffs to players, playing academically ineligible players, illegal recruiting tactics, illegal involvement of alumni in recruiting, etc. All the national news publications agree that your college's football program will be disbanded by the NCAA. One article also mentioned that during the past three years only 13 percent of senior football players managed to graduate on time. Additional speculation suggests the responsible parties including the coaching staff, athletic director, and college president will be dismissed by the board of trustees.

- Compute the amount of compensation paid to the new coach in each of his first three years.
- Did the performance measures in the coach's contract foster goal congruence? Explain.
- Would the coach's actions have been different if other performance measures were added to the compensation contract? Explain.
- What performance measures should be considered for the next coach's contract, assuming the football program is kept alive?

41. *Coca-Cola's new chairman and chief executive officer, Douglas Daft, said he will tie his compensation to diversity goals and create an executive position to develop strategies for promoting minorities.*

The moves come as Coke faces a lawsuit by current and former African-American employees accusing the soft-drink company of racial bias.

In a memo e-mailed in March 2000 to employees worldwide, Mr. Daft said Coke will establish "a series of goals, objectives and targets" for achieving diversity throughout the company "over the next few months," and that "everyone in the organization, including the CEO, will be held accountable for meeting them." He added that his "success and compensation" will be tied to meeting the diversity goals, "and the same will be true throughout the management ranks."

SOURCE: Betsy McKay, "Coke CEO to Tie Pay to Diversity Goals, Create Post on Promotion of Minorities," *The Wall Street Journal* (March 10, 2000), p. A3. Permission conveyed through the Copyright Clearance Center.

- Assume the stock market reacted negatively to the news article. Discuss why the market might react this way.
- Assume the stock market reacted positively to the news article. Discuss why the market might react this way.
- Discuss any problems you perceive in tying diversity objectives to managerial rewards.
- Is tying managerial rewards to diversity an ethical way to change managerial behaviors regarding hiring minorities?

REALITY CHECK

42. United for a Fair Economy is a group that believes the disparity in pay in the United States between top executives and ordinary workers has grown too large. The group offers research data to support their position. Find the group's Internet site and read the article entitled "A Decade of Executive Excess: The 1990s." Read the article and write a report that summarizes the article and expresses your views of the group's arguments.



43. In a survey, 649 managers responded to a questionnaire and provided their opinions from an ethical perspective as to the acceptability of manipulating accounting earnings to achieve higher managerial compensation. One of the questions dealt with the acceptability of changing a sales practice to pull some of next year's sales into the current year so that reported current earnings could be pushed up. The results of the survey indicated that about 43 percent of the respondents felt this practice was ethically acceptable, 44 percent felt the practice was ethically questionable, and 13 percent felt the practice was ethically unacceptable.

Other results of the survey indicate the managers felt large manipulations were more unethical than small manipulations, and income-increasing manipulations were more ethically unacceptable than income-decreasing manipulations.

SOURCE: Adapted from William J. Bruns and Kenneth A. Merchant, "The Dangerous Morality of Managing Earnings," *Management Accounting* (August 1990), pp. 22–25. Reprinted from *Management Accounting*. Copyright by Institute of Management Accountants, Montvale, N.J.

- a. If managers are able to manipulate earnings to effect a change in their pay, is this a signal of a weakness in the pay-for-performance plan? Explain.
 - b. In your view, does the materiality of a manipulation partly determine the extent to which the manipulation is ethically acceptable?
 - c. Describe any circumstances in which you believe manipulations would be ethically acceptable.
44. Recall from your academic career the various ways in which your academic performance has been measured and rewarded. Have the ways that your class grades been determined always provided the best indications of performance? Provide at least two positive and two negative examples. What would you have done to change the measurement system in the negative examples?

45. When David P. Gardner, president of the University of California, announced his retirement unexpectedly in April 1992, he received a severance package worth \$1 million—in a year in which the university's budget was cut by \$255 million. The university also announced that student fees would rise for the third straight year—for a three-year total increase of 85 percent.

Mr. Gardner, who retired early at age 58, earned an official salary of \$243,500—double that of California's governor. But his actual compensation was more than \$400,000. And although his official pension would be \$126,000 a year, he received an additional \$933,000 when he departed.

In addition to Mr. Gardner's base salary, the regents found ways to pay him an additional \$160,000 annually. Deferred income, severance pay, and a special supplemental retirement program made the difference. In fact, a secret deferred-income plan was established by the regents in 1988 for about a dozen top UC executives, after a private study concluded that their compensation lagged behind that of top administrators in a nationwide comparison group of universities. (The conclusions of the study were challenged by the California Postsecondary Education Commission, an independent state agency.)

SOURCE: Adapted from Jon Wiener, "Lavish Compensation Is Not Appropriate for Top Executives at Public Universities," *Chronicle of Higher Education* (November 25, 1992), p. B3.

- a.** Assume you were one of the students in the UC system. Discuss your perceptions about Mr. Gardner's compensation package.
- b.** How ethical do you think it was for Mr. Gardner to accept such a compensation package? Consider both the information in the comparative study and the budget problems that California was experiencing.
- c.** Could this simply be a case of trying to retain the "best and the brightest" in a not-for-profit institution? Discuss the rationale for your answer.