



CHAPTER 14

Variable Pay and Executive Compensation

After you have read this chapter, you should be able to:

- Define *variable pay* and give examples of three types of variable pay.
- Identify four guidelines for successful incentive programs.
- Discuss three types of individual incentives.
- Explain the three different ways that sales employees typically are compensated.
- Identify key factors that must be addressed when using team variable pay plans.
- Discuss why gainsharing, profit-sharing, and employee stock ownership plans (ESOPs) have grown as organizational incentive plans.
- Identify the components of executive compensation and discuss criticisms of the reasonableness of executive compensation.

HR TRANSITIONS

Employees Stock Up

Variable pay in the form of incentives for employees can take many forms, ranging from commissions for sales representatives to annual bonuses for managers. But a growing number of companies are moving beyond the typical incentives given to lower-level workers and using stock options throughout the organization. Traditionally, stock options have been provided only to a limited number of top-level executives and senior managers. Now employee stock incentives at all levels are creating strong results for employers and employees alike.

One well-known firm using stock options effectively is Home Depot. Founded in 1978, Home Depot has numerous home improvement and building supply stores throughout the United States. Since its early years, Home Depot has provided stock option incentives for management and administrative employees. Additionally, the firm has a plan that permits virtually all other employees to buy Home Depot stock at a discounted price. Home Depot's CEO, Arthur Blank, has stated that the employee stock plans are at the heart of the firm's success. Blank believes that the stock plan has contributed to the feeling among all employees that they "own" their stores, which leads to higher internal morale and greater attention to customer service. Another benefit of the stock program is that Home Depot employees are more likely to resist recruiting efforts by other employers because of their stock ownership in the company.

The Home Depot stock ownership program has paid off for employees, as well. One share of Home Depot stock bought in 1981 would be worth over 100 shares today. As a result, over 1,000 Home Depot employees have company stock valued at \$1 million or

more. Many of these "millionaires" are not executives, but administrative and sales employees throughout the company and its stores. In early 1998 Home Depot stock split 2 for 1, and some managers reported that employees were cheering and yelling like they were at a sports pep rally.

Home Depot's biggest competitor also has established employee stock programs. Lowe's, based in North Carolina, provides stock equivalents up to 13% of base pay to employees with one year of service or more. Lowe's has found that its stock program provides a significant recruiting leverage when Lowe Stores are opened in tight labor markets.

Edison Project stock. When the stock goes public, all full-time staff members can purchase stock at a price set lower than the market price.

Employees must stay with Edison for at least five years to fully vest all of their shares, and then the employees can keep any appreciated value of the stock. A sliding scale based on job responsibilities identifies the number of Edison shares that can be purchased. In addition to the stock purchase plan, Edison teachers and administrative staff can earn annual cash bonuses upon the performances of their students against yearly objectives set by local school districts.

Many other firms have employee

Now, employee stock incentives at all levels are creating strong results for employers and employees alike.

Employee stock programs are spreading to other industries as well. One of the most interesting employee stock programs established recently is at the Edison Project. This firm contracts with public schools to operate public schools for fees equivalent to the costs currently incurred by local school districts. Despite significant resistance by traditional educational administrators and teachers' unions, the Edison Project has had significant success in raising student test scores and improving the educational performance of students, many of whom are in lower socioeconomic neighborhoods. Several years after starting the Edison Project, Chris Whittle—its founder—developed a plan to begin providing stock options. In the year 2000, teachers and administrators in over 50 schools that Edison operates in Florida, Colorado, Kansas, and other states will receive shares of

stock plans as well, and these plans have significantly rewarded employees for organizational performance. The major concern with such programs is if the value of the stock declines significantly over time. The incentive value of the stock is reduced when employees' stock value declines, as happened in 1998 when the stock market temporarily dropped. However, these stock plans are designed to reward longer-term performance and employee loyalty, and many of the stock prices rebounded. Obviously, stock prices do not always go up; and when stock values decline, employee anxiety increases. Nevertheless, using stock plans as a means of providing additional compensation to employees appears to help focus employee efforts on increasing organizational performance. Certainly, the "millionaires" at Home Depot, Lowe's, and other firms would agree.¹

“The new world of work demands employee performance instead of loyalty, creativity instead of compliance, and earned rewards instead of entitlements.”

THE ECONOMIST

A growing number of employers have established compensation programs for employees that provide additional compensation linked to individual, group or team, and organizational performance. For example, individual employees at a telecommunications company receive extra pay if they describe special calling features, such as call-waiting and caller identification, and customers mention their names when signing up for the services. For many sales representatives, commissions tied to sales performance are a significant portion of total compensation. At the executive level, many individuals receive stock options tied to the longer-term performance of firms and their stock prices. All of these examples are illustrations of variable pay plans.

Variable Pay: Incentives for Performance

Variable pay

Compensation linked to individual, team, and/or organization performance.

Variable pay is compensation linked to individual, team, and/or organization performance. Traditionally also known as *incentives*, variable pay plans are attempts to tie additional tangible rewards given to employees for performance beyond normal expectations. The philosophical foundation of variable pay rests on several basic assumptions:

- Some jobs contribute more to organizational success than others.
- Some people perform better than others.
- Employees who perform better should receive more compensation.
- A portion of some employees' total compensation should be given to reward above-satisfactory performance.

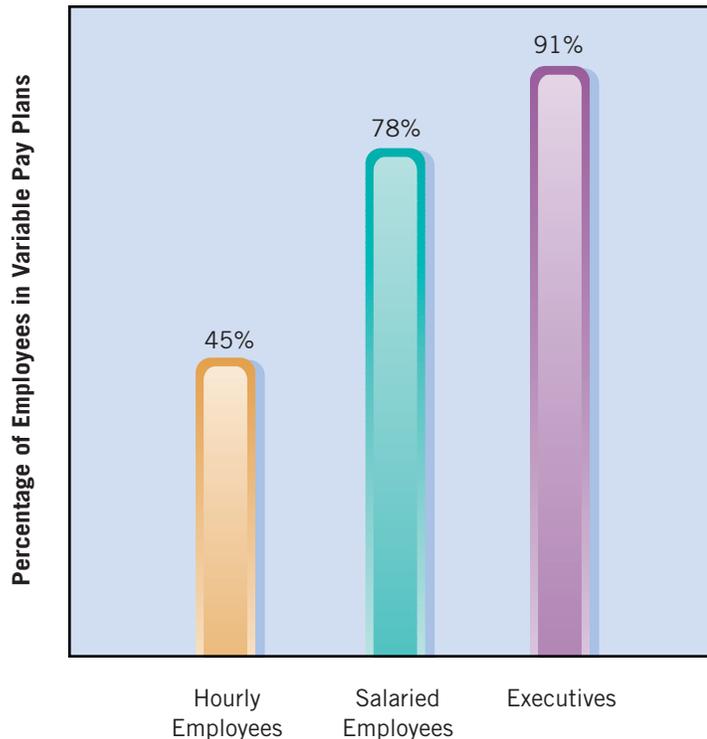
Contrast the assumptions above with a pay system based on seniority or length of service:

- Time spent each day is the primary measure of short-term contribution.
- In the long term, length of service with the organization is the primary differentiating factor among people.
- Differences in individual contributions to the organization are recognized through different base pay levels.
- Giving additional performance rewards to some people but not others is divisive and hampers employees working together.

The prevalence of variable pay programs can be seen in a study of over 400 large companies. As Figure 14–1 shows, almost half of all surveyed firms offer variable pay programs to hourly employees, while most offer such plans to executives. Generally, sales employees and executives have higher amounts of variable pay, which usually is linked to sales performance.² It is evident that variable pay plans have become significant to both employers and employees.

Types of Variable Pay

Variable pay plans can be established that focus on individual performance, team or group performance, and on organization-wide performance. An important fea-

FIGURE 14-1 Variable Pay Plan Participation by Employee Groups

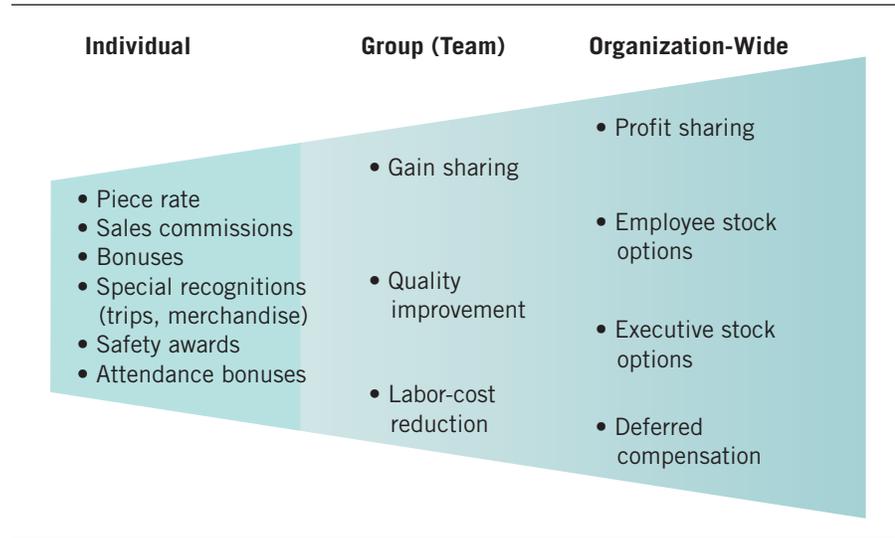
SOURCE: Based on data in *1998/1999 Compensation Budget Survey of Fortune 1000 Companies* (Secaucus, NJ: Buck Consultants, 1998).

ture of variable pay plans is that incentives increase the degree of cooperation in teams, whereas individual incentives do not.

Individual incentives are given to reward the effort and performance of individuals. Some of the most common means of providing individuals variable pay are piece-rate systems, sales commissions, and bonuses. Other means include special recognition rewards such as trips or merchandise. Two widely used individual incentives focus on employee safety and attendance. One of the difficulties with individual incentives is that an employee may focus on what is best individually and may block or inhibit performance of other individuals with whom the employee is competing. That competition particularly occurs if only the top performer or winner receives incentives. This is one reason why team or group incentives have been developed.

When an entire work group or *team* is rewarded for its performance, more cooperation among the members is required and usually forthcoming. However, competition among different teams for rewards can lead to decline in overall performance under certain circumstances. The most common types of *team* or *group incentives* are gainsharing plans where employee teams that meet certain goals share in the gains measured against performance targets. Often, gainsharing programs focus on quality improvement, labor-cost reduction, and other measurable results.

Organization incentives reward people for the performance of the entire organization. This approach reduces individual and team competition and assumes that

FIGURE 14-2 *Types of Variable Pay Plans*

all employees working together can generate better organizational results that lead to better financial performance. These programs share some of the financial gains to the firm through payments to employees. The payments often are paid as an additional percentage of each employee's base pay. Also, organizational incentives may be given as a lump-sum amount to all employees, or different amounts may be given to different levels of employees throughout the organization. The most prevalent forms of organization-wide incentives are profit-sharing plans and employee stock plans. For senior managers and executives, variable pay plans often are established to provide stock options and other forms of deferred compensation that minimize the tax liabilities of the recipients. Figure 14-2 shows some of the programs under each type.

Successes and Failures of Variable Pay Plans

As variable pay has grown in popularity, it is becoming evident that these plans have both succeeded and failed. One study of employers found that despite the fact that 61% of the companies have variable pay plans, almost half of them did not achieve their performance targets for the year. But to avoid negative employee reactions, many of those companies paid out 85% of the incentives anyway. The good news from the study is that over half of the variable pay plans achieved their performance objectives.³ Executive-focused variable pay plans tend to be viewed as more successful than those used with lower-level, non-management employees.⁴

The reactions of employees are crucial to how variable pay plans are accepted. It is interesting that in a study of over 2,000 workers from a variety of companies, most respondents said they want performance rewards included in their base pay, rather than as one-time payments. Also, the employees strongly preferred individual rewards over team or organization incentives.⁵

These studies and others highlight the fact that neither of the polar extremes—the view that incentives do not work versus the view that incentives are a

panacea—appears to be the case. Also, the enthusiasm that many employers and managers have for variable pay plans is not matched by many workers. The key to success seems to be to combine incentives with employee participation in the process.

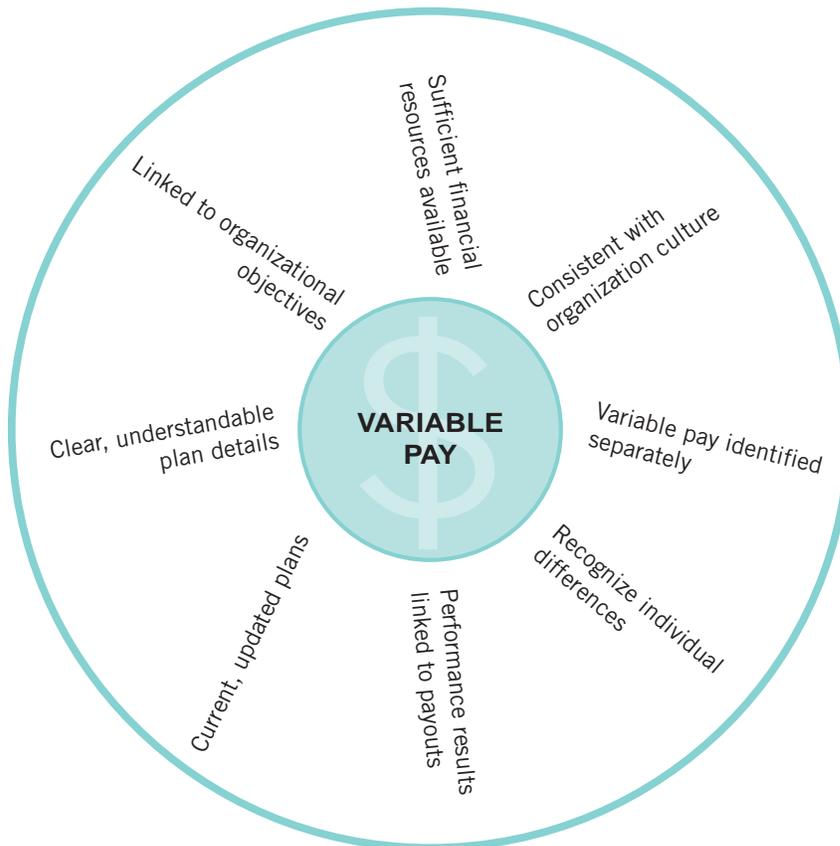
In summary, it appears that variable pay plans are successful under certain circumstances. As Figure 14–3 indicates, a number of factors affect the success of variable pay plans. The next section discusses the guidelines for establishing successful variable pay plans.

Guidelines for Variable Pay Plans

Providing variable pay through incentive systems can be complex and can take many forms. However, certain general guidelines are useful in establishing and maintaining successful variable pay systems.

RECOGNIZE ORGANIZATIONAL CULTURE AND RESOURCES An important factor in the success of any variable pay program is that it be consistent with both the culture and the financial resources of the organization. For example, if an organization is autocratic and adheres to traditional rules and procedures, an incentive

FIGURE 14-3 *Conditions for Successful Variable Pay Plans*



system that rewards flexibility and teamwork is likely to fail. The incentive plan is being “planted” in the wrong growing environment.⁶

Any variable pay system requires an organizational climate of trust and cooperation between employees and managers.⁷ As the amount of trust between employees and managers increases, and the objectivity of the criteria used for determining rewards becomes greater, the likelihood of a successful incentive program increases. If workers have a high level of trust and good working relationships with their superiors, they may accept more subjective performance measures. But low trust of management leads to a low probability of success for a variable pay system.

MAKE VARIABLE PAY PLANS UNDERSTANDABLE Another key factor for establishing effective variable pay plans is to make them easy for employees to understand. If these plans are clear, employees can track performance against the objectives of the plan and see what variable pay they are earning. However, if plans are developed that are too complicated and employees need calculators, worksheets, and assistance from analysts to determine where they are against incentive target levels, then the plans have lost some of their motivational value. The more complicated a plan is, the more difficult it will be to communicate it meaningfully to employees.⁸

Many plans include several performance criteria, which generally are recommended by experts in variable pay designs. But having two or three areas to focus on should not result in a significant number of steps being required for employees to compute their incentive amounts and for managers to be able to explain what further performance targets need to be met. In summary, effective variable pay plans give employees clear information on why the employer is establishing the plan, how the employees’ performance will be evaluated, what their contributions will produce for the organization, and what rewards they will receive.⁹



LOGGING ON . . .

Strategies for Incentives

This website is from a company specializing in incentive programs. An overview of the strategies and philosophies used when developing an incentive program is available.

<http://www.hinda.com/index.htm>

KEEP INCENTIVE PLANS CURRENT An incentive system should consistently reflect current technological and organizational conditions. Offering an incentive for sales representatives to sell older-generation equipment in order to clear it out of stock might be appropriate until that merchandise is gone, but no incentive may be needed to sell high-demand items.

Incentive systems should be reviewed continually to determine whether they are operating as designed. Follow-up, through an attitude survey or other means, will determine if the incentive system is actually encouraging employees to perform better. If it is not, then managers should consider changing the system.

TIE VARIABLE PAY TO DESIRED PERFORMANCE Variable pay systems should be tied as much as possible to desired performance. Employees must see a direct relationship between their efforts and their financial rewards.¹⁰ Further, both employees and managers must recognize that incentives are most effective when employees can see clearly that their extra efforts lead to increased performance and desirable rewards.¹¹

Because people tend to produce what is measured and rewarded, it is important to make sure that what is being rewarded ties to organizational objectives. Also, often multiple measures are used to assure that various performance dimensions are not omitted. For example, assume a hotel reservation center sets incentives for its employees to increase productivity by lowering their time spent

per call. That reduction may occur, but customer service and the number of reservations made might drop as employees rush callers to reduce talk time.

Indeed, linking pay to performance may not always be appropriate. For example, if the output cannot be objectively measured, management may not be able to reward the higher performers with more pay. Managers may not even be able to accurately identify the higher performers.

RECOGNIZE INDIVIDUAL DIFFERENCES Incentive plans should provide for individual differences. People are complex, and a variety of incentive systems may have to be developed to appeal to various organizational groups and individuals. Therefore, variable pay plans must be designed carefully. As illogical as it may seem, informal group pressure and sanctions commonly are used to restrict the amount that individuals produce, even if individual pay is reduced as a result. Those who seek to maximize their earnings by exceeding group-imposed limits are labeled “rate busters” or something even more graphic. Rate restrictors often feel they are being made to suffer by comparison with the higher producers. Therefore, designers of incentive plans first must look at individual issues.

IDENTIFY VARIABLE PAY SEPARATE FROM BASE PAY Successful variable pay plans clearly identify how much the variable pay plan provides to employees separate from their base pay amounts. That separation makes a clear connection between performance and pay. It also reinforces the notion that one part of the employees’ pay must be “re-earned” in the next performance period.



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Incentive Plan Design

Read this section containing incentive plan design issues and list them, so that they can be reviewed as you read the information on individual and group incentives.

Individual Incentives

Individual incentive systems attempt to relate individual effort to pay. Conditions necessary for the use of individual incentive plans are as follows:

- *Identification of individual performance:* The performance of each individual can be measured and identified because each employee has job responsibilities and tasks that can be categorized from those of other employees.
- *Independent work:* Individual contributions result from independent work and effort given by individual employees.
- *Individual competitiveness desired:* Because individuals generally will pursue the individual incentives for themselves, competition among employees will occur. Therefore, independent competition whereby some individuals “win” and others do not must be desired.
- *Individualism stressed in organizational culture:* The culture of the organization must be one that emphasizes individual growth, achievements, and rewards. If an organization emphasizes teamwork and cooperation, then individual incentives will be counterproductive.

Piece-Rate Systems

The most basic individual incentive system is the piece-rate system, whether of the straight or differential type. Under the **straight piece-rate system**, wages are determined by multiplying the number of units produced (such as garments sewn or customers contacted) by the piece rate for one unit. The rate per piece does not change regardless of the number of pieces produced. Because the cost is

Straight piece-rate system

A pay system in which wages are determined by multiplying the number of units produced by the piece rate for one unit.

HR PERSPECTIVE

Piece-Rate Plan Clear Winner at Safelite Glass

Many organizations attempt to link employee performance to compensation. One of the oldest programs of this type is a piece-rate plan, whereby employees are paid only for what they produce. At Safelite Glass Corporation, this traditional plan appears to have produced payoffs in higher productivity for the company and more pay for employees.

Safelite operates nationally, providing auto glass installation services. Several years ago, Safelite management decided to change from

hourly pay for installation employees to a piece-rate plan. To avoid creating employee anxiety, Safelite guaranteed a base wage of \$11 per hour to installers. But Safelite also offered the installers an alternative plan, under which they could receive \$20 per installed unit. To ensure that quality standards were met, windshields installed improperly or broken were replaced at no additional pay. Using a workflow and tracking system, the firm could identify each installer's work.

The success of the program exceeded most expectations. Individual productivity increased on average 20%, resulting in installer's average pay increasing by 10%. The company output also increased. Closely related, employee turnover and absenteeism declined, especially among the most productive workers. Thus, Safelite could see clearly the link between managers and employees, organizational and individual performance, and the rewards generated by that performance.¹²

Differential piece-rate system

Pays employees one piece-rate wage for units produced up to a standard output and a higher piece-rate wage for units produced over the standard.



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Piece-Rate Determination

To review the wage and hour regulations regarding determining the overtime rates for employees paid on piece rate plans, see this section.

Bonus

A one-time payment that does not become part of the employee's base pay.

the same for each unit, the wage for each employee is easy to figure, and labor costs can be accurately predicted.

A **differential piece-rate system** pays employees one piece-rate wage for units produced up to a standard output and a higher piece-rate wage for units produced over the standard. Developed by Frederick W. Taylor in the late 1800s, this system is designed to stimulate employees to achieve or exceed established standards of production.

Managers often determine the standards, or quotas, by using time and motion studies. For example, assume that the standard quota for a worker is set at 300 units per day and the standard rate is 14 cents per unit. For all units over the standard, however, the employee receives 20 cents per unit. Under this system, the worker who produces 400 units in one day will get \$62 in wages (300×14 cents) + (100×20 cents). There are many possible combinations of straight and differential piece-rate systems. The specific system used by a firm depends on many situational factors. The effects of a piece-rate system can be seen in the HR Perspective on Safelite Glass Corporation in Columbus, Ohio.

Despite their incentive value, piece-rate systems are difficult to use because standards for many types of jobs are difficult and costly to determine. In some instances, the cost of determining and maintaining the standards may be greater than the benefits derived. Jobs in which individuals have limited control over output or in which high standards of quality are necessary also may be unsuited to piecework.

Bonuses

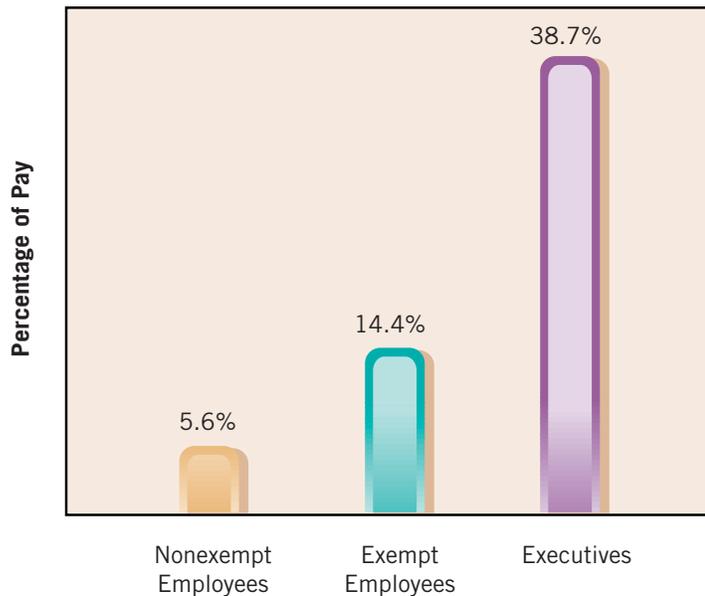
Individual employees may receive additional compensation payments in the form of a **bonus**, which is a one-time payment that does not become part of the employee's base pay. Generally, bonuses are less costly to the employer than

other pay increases because they do not become part of employees' base wages, upon which future percentage increases are figured. Growing in popularity, individual incentive compensation in the form of bonuses often is used at the executive levels of an organization, but bonus usage also is spreading to lower-level jobs, as Figure 14–4 indicates.

Bonuses also can be used to reward employees for contributing new ideas, developing skills, or obtaining professional certifications. When the skills or certification requirements are acquired by an employee, a pay increase or a one-time bonus may follow. For example, a financial services firm provides the equivalent of two week's pay to employees who master job-relevant computer skills. Another firm gives one week's pay to members of the HR staff who obtain their professional certifications such as PHR, SPHR, CCP, and others discussed in Chapter 1. Firms in the information technology industry pay bonuses for obtaining special technical skills in order to keep employees from looking for new jobs elsewhere using their newly acquired skills and certification.¹³

A bonus recognizes performance by both the employee and the company. When both types of performance are good, bonuses go up. When both are bad, bonuses go down. When an employee has done poorly in a year that was good for the company, most employers base the employee's bonus on individual performance. It is not always as clear what to do when an employee does well but the company does not. However, a growing number of companies are asking employees to put a portion of their pay "on the line." While offering big incentive bonuses for high performance, they are withholding them when performance is poor and insisting that employees share *both* the risks and rewards of business.

FIGURE 14–4 Bonuses as Percentage of Salary (averages for non-sales employees)



SOURCE: Buck Consultants, as reported in "Compensation Trends and Strategies," *Journal of Accountancy*, January 1998, 87.

One method of determining an employee's annual bonus is to compute it as a percentage of the individual's base salary. Often, such programs pay bonuses only if specific individual and organizational objectives have been achieved. Though technically this type of bonus is individual, it comes close to being a group or organizational incentive system. Because it is based on the profits of the division, management must consider the total performance of the division and its employees.

Whatever method of determining bonuses is used, legal experts recommend that bonus plans be described in writing, especially for key managers. A growing number of lawsuits are being filed by employees who leave organizations either voluntarily or involuntarily, demanding payment of bonuses promised to them.¹⁴

Special Incentive Programs

There are numerous special incentive programs that provide awards to individuals. These programs can take various forms, ranging from one-time contests for meeting performance targets to rewards for performance over time. For instance, safe-driving awards are given for truck drivers who have no accidents or violations during a year. Although special programs also can be developed for groups and for entire organizations, these programs often focus on rewarding only high-performing individuals.



LOGGING ON . . .

Incentives at NASA

An example of the incentive awards program used for government programs is found at this website. The program has been successful at NASA.

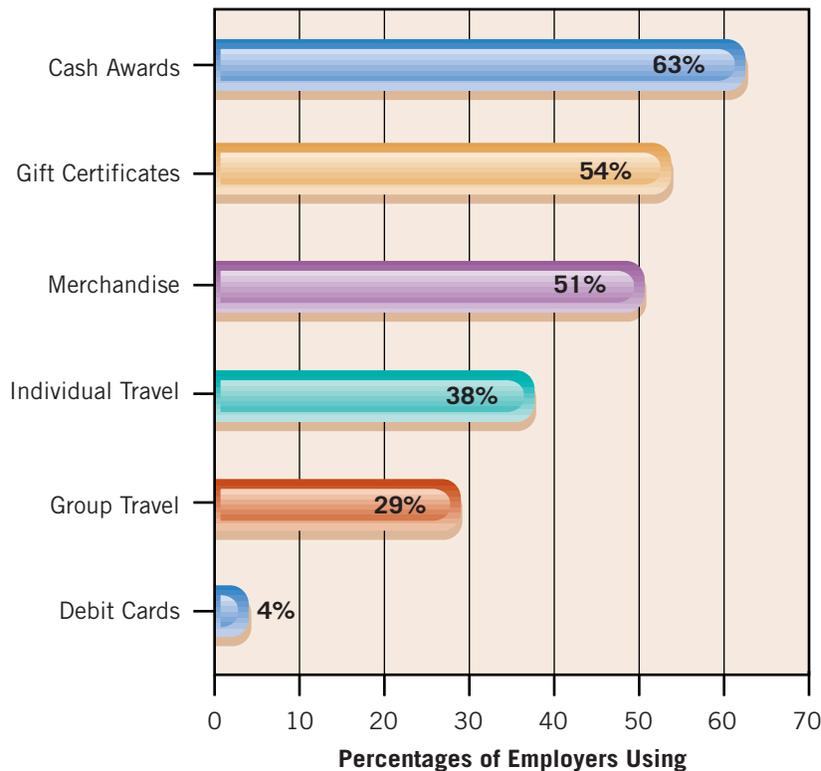
<http://huminfo.arc.gov/Awards/awards.html>

INCENTIVE PROGRAM AWARDS Cash merchandise, gift certificates, and travel are the most frequently used rewards, as Figure 14–5 shows. Cash is still highly valued by many employees because they have discretion on how to spend it; however, travel awards, particularly those to popular destinations such as Disney World, Las Vegas, Hawaii, and international locations, appeal to many employees. In one study, Goodyear Tire & Rubber Company conducted an experiment in which some employees received cash and another set of employees received merchandise and other non-cash rewards. The employees receiving the non-cash incentives outperformed those receiving only cash by 46%. The study concluded that many employees like the continuing “trophy” value of merchandise rather than the short-term usage of cash.¹⁵

RECOGNITION AWARDS Another type of program recognizes individual employees for their performance or service. For instance, many organizations in service industries such as hotels, restaurants, and retailers have established “employee of the month” and “employee of the year” awards. In the hotel industry over half of the hotels surveyed have recognition awards for desk clerks, housekeepers, and other hourly employees, with the awards being triggered by favorable guest comment cards.¹⁶

It is important that recognition awards be given to recognize specific efforts and activities targeted by the organization as important.¹⁷ While the criteria for selecting award winners may be subjectively determined in some situations, formally identified criteria provide greater objectivity and are more likely to reward performance, rather than being seen as favoritism. When giving recognition awards, organizations should use specific examples to describe clearly how those receiving the awards were selected.

SERVICE AWARDS Another common type of reward given to individual employees is the *service award*. Although these awards often may be portrayed as

FIGURE 14-5 *Special Incentive Award Types*

SOURCE: *A Study of the Incentive Merchandise and Travel Marketplace* (Westfield, NJ: The Incentive Federation, Inc., 1997). Used with permission.

rewarding performance over a number of years, the reality is that they are determined by length of service, and performance plays little or no role.

Sales Compensation and Incentives

The compensation paid to employees involved with sales and marketing is partly or entirely tied to sales performance. Better-performing salespeople receive more total compensation than those selling less.

Sales Performance Measurement

Successfully using variable sales compensation requires establishing clear performance criteria and measures. Generally, no more than three sales performance measures should be used in a sales compensation plan.¹⁸ Consultants criticize many sales commission plans as being too complex to motivate sales representatives. Other plans may be too simple, focusing only on the salesperson's pay, not on organizational objectives. Although many companies use an individual's sales revenue compared to established quotas as the primary performance measure,

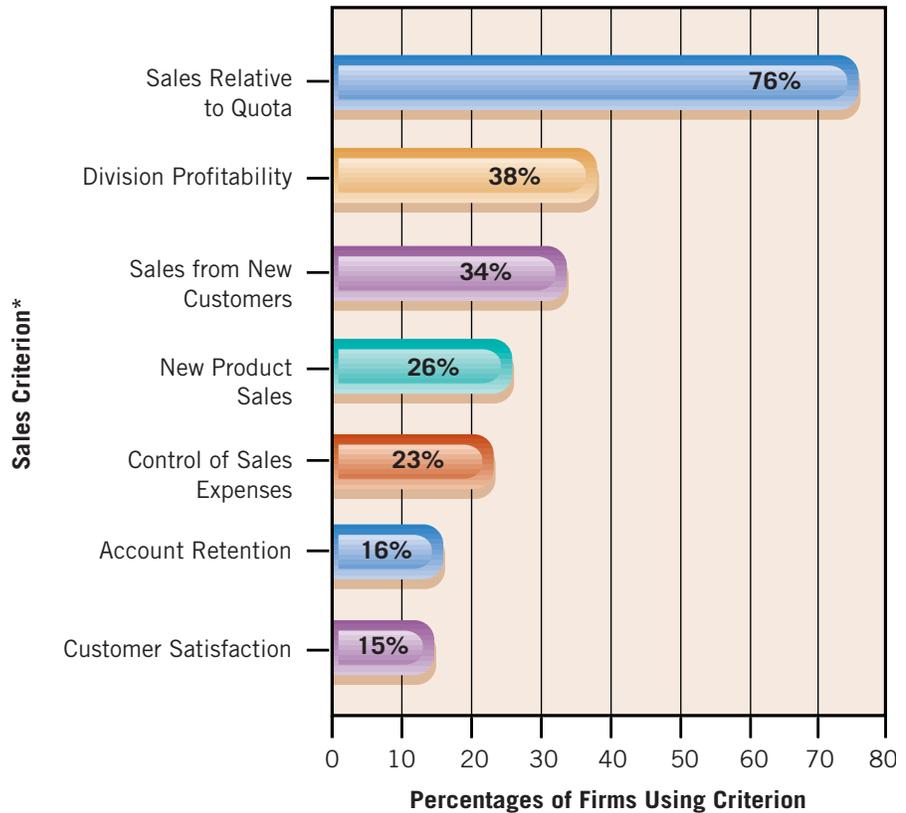
performance would be much better if these organizations used a variety of criteria, including obtaining new accounts and selling high-value versus low-value items that reflect marketing plans. Figure 14–6 shows the results of one study identifying the criteria used to determine incentive payments for salespeople.

Sales Compensation Plans

Sales compensation plans are generally of several different types. The types are based on the degree to which total compensation includes some variable pay tied to sales performance. A survey of over 260 firms found that plans providing salary with bonus (37%) and salary with commission and bonus (35%) were the most used types. Less used were plans providing commission only (24%) and salary only (5%).¹⁹ A look at each type of sales compensation follows next.

SALARY ONLY Some firms pay salespeople only a salary. The salary-only approach is useful when serving and retaining existing accounts is being emphasized more than generating new sales and accounts. This approach is frequently used to pro-

FIGURE 14–6 Sales Performance Criteria



*NOTE: Because multiple criteria may be used, the totals exceed 100%.
 SOURCE: Based on data in Kisson Joseph and Manohar U. Kalwani, "The Role of Bonus Pay in Salesforce Compensation Plans," *Industrial Marketing Management* 27 (1998), 147–159.

HR PERSPECTIVE

Balancing Sales Compensation and Ethical Concerns

Sales commission programs are widely used to compensate sales representatives. These programs are very effective at driving the behavior of sales representatives, especially if the sales performance measures are based wholly or mostly on sales volume and revenues. However, in a number of instances, performance-based sales employees have acted unethically. For instance, a major retailer paid commissions to employees for generating sales volume and revenue for auto parts in its auto repair centers. Upon closer scrutiny, the retailer discovered that in several cases representatives were convincing customers to buy unnecessary part replacements and have unnecessary repairs done. By doing so, the sales reps received higher commissions and met corporate performance targets. As a result of the investigation, which received widespread, negative press coverage, the retailer had to revamp its incentive plans.

Other industries have seen similarly shady behavior as well. Several brokerage and insurance firms have been investigated because sales representatives have misrepresented financial products and services that were marketed to a wide range of customers. In some cases large fines and criminal indictments have been handed down.

Some legal experts and academics have voiced concerns that performance-driven sales incentives encourage unethical behavior, particularly if commissions are the sole basis for determining the compensation of sales representatives. These critics charge that sales commission programs align the interest of sales reps with the firm, rather than with those of customers and clients. This concern is especially true if the customer purchases are likely to be “one-time” purchases, such as a used car or a life insurance policy, where the likelihood of repeat pur-

chases and a continuing customer relationship is lower.

Some solutions to address these ethical issues have included discontinuing commission-only plans, so that the basic income of sales reps does not solely depend on what they “hunt and kill.” Instead, proponents urge using a mixture of guaranteed base salary and lowered commission rates. Critics of sales compensation also suggest that other sales-related dimensions be used, such as customer service, repeat business, or customer satisfaction. For instance, sales commissions for investment brokers might be linked to increasing a client’s net portfolio value, rather than only to the trading commissions generated. How realistic such changes are in a variety of sales situations may be debated. But it is clear that ethical issues must be considered when developing and managing sales incentive plans.²⁰

protect the income of new sales representatives for a period of time while they are building up their sales clientele. It is also used when both new and existing sales reps have to spend considerable time learning about and selling customers new products and service lines. Generally, the salary-only approach may extend no more than six months, at which point sales plus commission or bonuses are implemented. However, one study found that salespeople who wanted extrinsic rewards were less effective in salary-only plans. They were less motivated to sell without additional performance-related compensation.²¹

STRAIGHT COMMISSION An individual incentive system widely used in sales jobs is the **commission**, which is compensation computed as a percentage of sales in units or dollars. Commissions are integrated into the pay given to sales workers in three common ways: straight commission, salary plus commission, and bonuses.

In the straight commission system, a sales representative receives a percentage of the value of the sales made. Consider a sales representative working for a

Commission

Compensation computed as a percentage of sales in units or dollars.

consumer products company. She receives no compensation if no sales are made, but for all sales made in her territory, she receives a percentage of the total amount. The advantage of this system is that the sales representative must sell to earn. The disadvantage is that it offers no security for the sales staff. This disadvantage can be especially pronounced when the product or service sold is one that requires a long lead time before purchasing decisions are made. Also, as the HR Perspective on the previous page indicates, commission-only plans may lead to unethical behavior of sales employees.

Draw

An amount advanced from and repaid to future commissions earned by the employee.

For these reasons just mentioned, some employers use a **draw** system, in which the sales representative can draw advance payments against future commissions. The amount drawn then is deducted from future commission checks. From the employer's side, one of the risks in a draw system is that future commissions may not be large enough to repay the draw, especially for a new or marginally successful salesperson. In addition, arrangements must be made for repayment of drawn amounts if an individual leaves the organization before earning the draw in commission.

SALARY PLUS COMMISSION OR BONUSES The most frequently used form of sales compensation is the *salary plus commission*, which combines the stability of a salary with the performance aspect of a commission. Many organizations also pay salespeople salaries and then offer bonuses as a percentage of base pay tied to meeting various levels of sales targets or other criteria. A common split is 70% salary to 30% commission, although the split varies by industry and with other factors.

Some sales organizations combine both individual and group sales bonus programs. In these programs, a portion of the sales incentive is linked to the attainment of group sales goals. This approach encourages cooperation and teamwork for the salespersons to work together. Team incentives in situations other than sales jobs are discussed next.

Team-Based Variable Pay

The growing use of work teams in organizations has implications for compensation of the teams and their members. Interestingly, while the use of teams has increased significantly in the past few years, the question of how to equitably compensate the individuals who compose the team remains one of the biggest challenges. As Figure 14–7 notes, there are several reasons why organizations have established group or team variable pay plans, and evidently these goals are being met in a number of organizations.

As seen in the results of a survey of the *Fortune* 1000 large companies, almost 70% of these large firms are using work teams in some manner. About 87% of the executives and HR professionals surveyed were positive about the use of teams. However, only 45% of those surveyed were positive about the ways those teams were being paid. Also, the satisfaction with team-based pay plans was lower than two years before, despite a significant increase in the use of teams.²²

Types of Team Incentives

Team-based reward systems use various ways of compensating individuals. The components often include individual wages and salaries in addition to team-

FIGURE 14-7 Why Organizations Establish Team Variable Pay Plans

based rewards. Most team-based organizations continue to pay individuals based either on the jobs performed or the individuals' competencies and capabilities. Several decisions about methods of distributing and allocating team rewards must be made.

Distributing Team Incentives

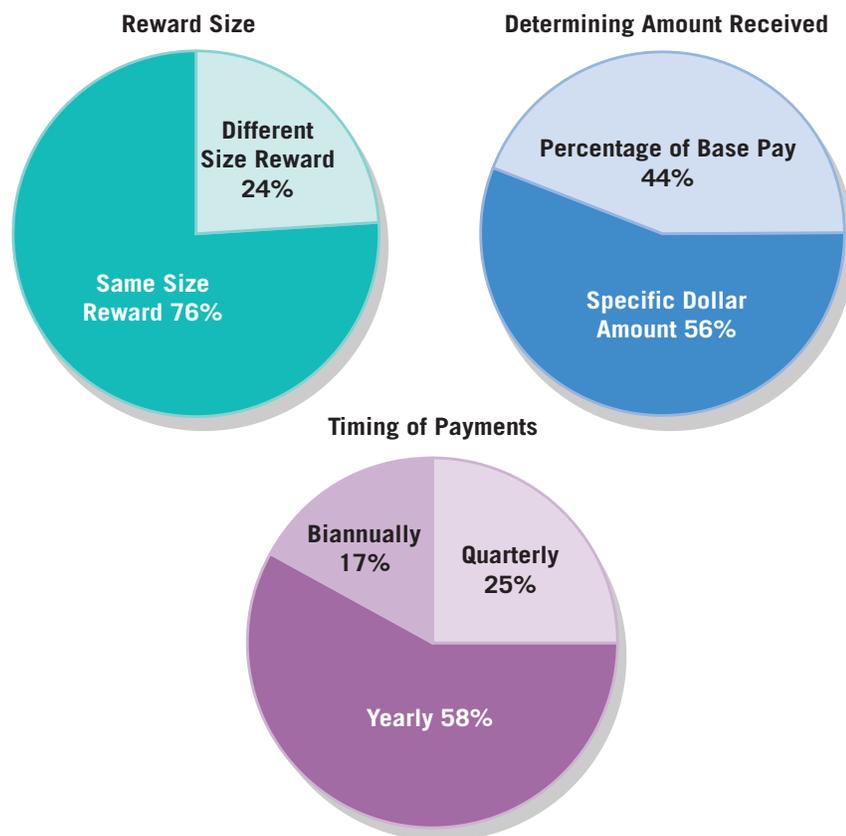
The two primary approaches for distributing team rewards are as follows:

- *Same size reward for each team member:* In this approach, all team members receive the same payout, regardless of job levels, current pay, or seniority.
- *Different size rewards for each team member:* Using this approach, individual rewards vary based upon such factors as contribution to team results, current pay, years of experience, and skill levels of jobs performed.

Generally more organizations use the same-size team reward approach as an addition to different levels of individual pay. This approach is used to reward team performance by making the team incentive equal, while still recognizing that individual pay differences exist and are important to many persons. The size of the team incentive can be determined either by using a percentage of base pay for the individuals or the team as a whole, or by offering a specific dollar amount. For example, one firm pays team members individual base rates that reflect years of experience and any additional training that team members have. The team reward is distributed to all as a flat dollar amount.

TIMING OF TEAM INCENTIVES How often team incentives are paid out is another important consideration. Some of the choices seen in firms with team-based incentives include payment monthly, quarterly, biannually, or annually. As Figure 14-8 on the next page shows, yearly is the most common period used. The shorter the time period, the more likely it is that employees will see a closer link to their efforts and the performance results that trigger the award payouts. A study of team rewards for quality management found that companies generally limited the team rewards to \$500 or less, so that the rewards could be paid out more frequently.²³ Naturally, the nature of the teamwork, measurement criteria, and organizational results must all be considered when determining the appropriate time period.

DECISION MAKING ABOUT TEAM-INCENTIVE AMOUNTS To reinforce the team concept, some team incentive programs allow group members to make decisions

FIGURE 14-8 *Characteristics of Team-Based Rewards*

SOURCE: Jacquelyn S. DeMatteo, et al., "Factors Related to the Successful Implementation of Team-Based Rewards," *ACA Journal*, Winter 1997, 20. Used with permission.

about how to allocate the team rewards to individuals. For example, in one division of Motorola, teams are given a lump sum amount and they decide how to divide up the money. Some teams vote, while others have a team leader decide.²⁴ In other companies teams divide the team "pot" equally, thus avoiding conflict and recognizing that all members contributed to the team results.

Although some teams actually make decisions on bonuses for their members, this practice seems to be the exception rather than the rule. Many companies find teams unwilling to handle pay decisions for coworkers. Team-based bonus plans present other problems as well. Should a member be rewarded for trying hard but not quite succeeding? What happens when extra money for a "superstar" has to come from other group members' forgoing their own bonuses to some extent? Team-based incentives present both opportunities and challenges when they are developed and implemented.

Problems with Team-Based Incentives

The difference between rewarding team members *equally* or *equitably* triggers many of the problems associated with team-based incentives. Rewards that are

distributed equally in amount to all team members may be perceived as “unfair” by employees who may work harder, have more capabilities, and perform more difficult jobs. This problem is compounded when a poorly performing individual negatively influences the team results. For instance, suppose that holding data-entry errors to below 2% is an objective that triggers payment of a group incentive. The presence of one or two poor performers who make numerous errors can result in the group being denied an incentive payment for a month. Unfortunately, even if management retrains or removes the poor performers, some incentive amounts already have been lost.

Equitable pay in the minds of many people means distributing the team rewards individually to recognize individual efforts and capabilities. One survey of employees working in teams found a relatively low level of employee satisfaction with rewards that are the same for all, rather than different amounts based on performance, which may be viewed more equitably.²⁵

In summary, it seems that the concept of people working in teams is seen as beneficial by managers and organization leaders. But employees still expect to be paid based on individual performance, to a large extent. Until this individualism is recognized and compensation programs developed that are viewed as more equitable by more “team members,” caution should be used in developing and implementing team-based incentives.

Successful Team-Based Incentives

The unique nature of the team and its members is important when establishing successful team-based rewards. One consideration is the history of the group and its past performance.²⁶ Use of incentives is more successful where groups have been used in the past and where those groups have performed well. However, simultaneously introducing the teamwork concept and changing to team-based incentives has not been as successful.

Another consideration for the success of team-based incentives is the size of the team. If a team becomes too large, employees may feel their individual efforts will have little or no effect on the total performance of the group and the resulting rewards. Incentive plans for small groups are a direct result of the growing number of complex jobs requiring interdependent effort. Team-based incentive plans may encourage teamwork in small groups where interdependence is high. Therefore, it is recommended that team-based performance measures be used.²⁷ Such plans have been used in many service-oriented industries, where a high degree of contact with customers requires teamwork.

Team incentives seem to work best when the following criteria are present:

- Significant interdependence exists among the work of several individuals, and teamwork and cooperation are essential.
- Difficulties exist in identifying exactly who is responsible for differing levels of performance.
- Management wants to create or reinforce teamwork and cooperation among employees.
- Rewards are seen as being allocated in a fair and equitable manner.
- Employee input is obtained in the design of the team-incentive plan.

If these conditions cannot be met, then either individual or organizational incentives may be more appropriate.

Organizational Incentives

An organizational incentive system compensates all employees in the organization based on how well the organization as a whole performs during the year. The basic concept behind organizational incentive plans is that overall efficiency depends on organizational or plant-wide cooperation. The purpose of these plans is to produce teamwork. For example, conflict between marketing and production can be overcome if management uses an incentive system that emphasizes organizational profit and productivity. To be effective, an organizational incentive program should include everyone from nonexempt employees to managers and executives. Common organizational incentive systems include gainsharing, profit sharing, and employee stock ownership plans (ESOPs).

Gainsharing

Gainsharing

The sharing with employees of greater-than-expected gains in profits and/or productivity.

Gainsharing is the sharing with employees of greater-than-expected gains in profits and/or productivity. Gainsharing attempts to increase “discretionary efforts”—that is, the difference between the maximum amount of effort a person can exert and the minimum amount of effort necessary to keep from being fired. It can be argued that workers currently are not paid for discretionary effort in most organizations. They are paid to meet the minimum acceptable level of effort required. However, when workers do exercise discretionary efforts, the organization can afford to pay them more than the going rate, because the extra efforts produce financial gains over and above the returns of minimal efforts.

DETERMINING PAYMENT AND PERFORMANCE MEASURES To begin a gainsharing program, management must identify the ways in which increased productivity, quality, and financial performance can occur and decide that some of the gains should be shared with employees. The most critical step is to involve employees at all levels in the gainsharing process, often by establishing a gainsharing task force or design team composed of managers and nonmanagers alike. Once the task force meets, there are two crucial decisions to be made: (1) How much gain is to be shared with employees? (2) What are the performance measures to be used?²⁸

Payouts of the gains can be made monthly, quarterly, semiannually, or annually, depending on management philosophy and the performance measures used. The more frequent the payouts, the greater the visibility of the rewards to employees. Therefore, given a choice, most firms with gainsharing plans have chosen to make the payouts more frequently than annually.

The rewards can be distributed in four ways:

- A flat amount for all employees
- Same percentage of base salary for all employees
- Percentage of the gains by category of employees
- Amount of percentage based on individual performance against measures

The first two methods generally are preferred because they promote and reward teamwork and cooperation more than the other two methods. Where performance measures are used, only those measures that employees actually can affect should be considered. Often, measures such as labor costs, overtime hours, and quality benchmarks are used. Both organizational measures and departmen-

tal measures may be used, with the gainsharing weighting being split between the two categories. Naturally, an individual's performance must be satisfactory in order for that individual to receive the gainsharing payments.

SUCCESS IN GAINSHARING The success or failure of incentive programs begins with the culture of the organization. Putting a gainsharing program in autocratically or in desperation to save a badly managed firm virtually guarantees failure. Inadequate financial systems, severe external competitive conditions, and government constraints also inhibit the success of gainsharing programs. Simply offering gainsharing payouts may not be enough to generate much participation in the plan. Negative attitudes toward the gainsharing plan and management can lead to nonparticipation by the employees. However, gainsharing certainly *can* work to improve performance, as the closing case in this chapter on Baltimore County indicates.

IMPROSHARE A number of gainsharing-type plans have been devised. One is Improshare, which stands for Improved Productivity through Sharing. Improshare was created by Mitchell Fein, an industrial engineer. It is similar to a piece-rate plan except that it rewards all workers in the organization. Input is measured in hours and output in physical units. A standard is calculated and weekly bonuses are paid based on the extent to which the standard is exceeded. Generally, the Improshare programs have resulted in productivity gains.

SCANLON PLAN Since its development in 1927, the Scanlon plan has been implemented in many organizations, especially in smaller unionized industrial firms. The basic concept underlying the Scanlon plan is that efficiency depends on teamwork and plant-wide cooperation.

The system is activated through departmental employee committees that receive and review cost-saving ideas submitted by employees. Suggestions beyond the scope of the departmental committees are passed to the plant screening committee for review. Savings that result from suggestions are passed on to all members of the organization.

Incentive rewards are paid to employees on the basis of improvements in preestablished ratios. Ratios of labor costs to total sales value or total production or total hours to total production are the most commonly used. Savings due to differences between actual and expected ratios are placed in a bonus fund. A predetermined percentage of this fund is then split between employees and the organization.

The Scanlon plan is not a true profit-sharing plan, because employees receive incentive compensation for reducing labor costs, regardless of whether the organization ultimately makes a profit. Organizations that have implemented the Scanlon plan have experienced an increase in productivity and a decrease in labor costs. Also, employee attitudes have become more favorable, and cooperation between management and workers has increased.

RUCKER PLAN The Rucker plan, almost as old as the Scanlon plan, was developed in the 1930s by the economist Allan W. Rucker. The Scanlon formula measures performance against a standard of labor costs in relation to the dollar value of production, whereas the Rucker formula introduces a third variable: the dollar value of all materials, supplies, and services that the organization uses.

The Rucker formula is calculated as follows:

$$\frac{\$ \text{ Value of Labor Costs}}{\$ \text{ Value of Production} - \$ \text{ Value of Materials, Supplies, Services}}$$

The result is what economists call the “value added” to a product by the organization. The use of value added rather than the dollar value of production builds in an incentive to save on other inputs.

Profit Sharing

Profit sharing

A system to distribute a portion of the profits of the organization to employees.

As the name implies, **profit sharing** distributes a portion of organizational profits to employees. Typically, the percentage of the profits distributed to employees is agreed on by the end of the year before distribution. In some profit-sharing plans, employees receive portions of the profits at the end of the year; in others, the profits are deferred, placed in a fund, and made available to employees on retirement or on their leaving the organization. Figure 14–9 shows how profit-sharing plans can be set up.

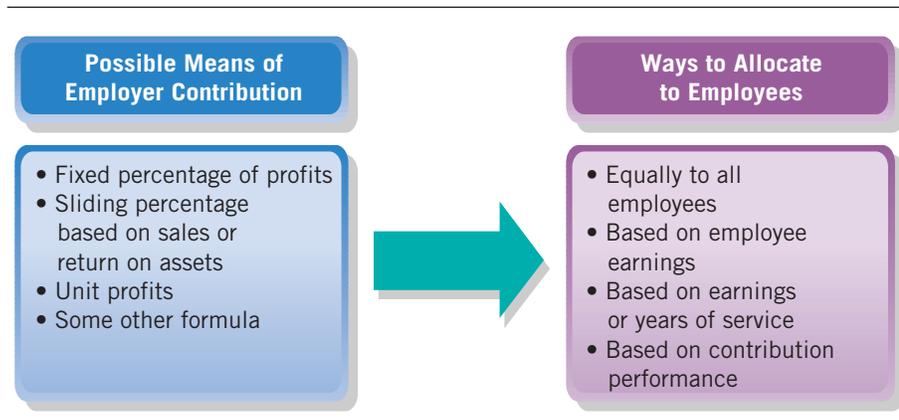
Unions sometimes are skeptical of profit-sharing plans, because such plans only work when there are profits to be shared. Often, the level of profits is influenced by factors not under the employees’ control, such as marketing efforts, competition, and elements of executive compensation. However, in recent years, organized labor has supported profit-sharing plans in which employees’ pay increases are tied to improved company performance.

OBJECTIVES OF PROFIT-SHARING PLANS The primary objectives of profit-sharing plans are to:

- Improve productivity
- Recruit or retain employees
- Improve product/service quality
- Improve employee morale

DRAWBACKS OF PROFIT-SHARING PLANS When used throughout an organization, including lower-echelon workers, profit-sharing plans can have some drawbacks. First, management must be willing to disclose financial and profit information to

FIGURE 14–9 *Profit-Sharing Plan Framework*



employees. As many people know, both the definition and level of profit can depend on the accounting system used and decisions made. Therefore, to be credible, management must be willing to disclose sufficient financial and profit information to alleviate the skepticism of employees, particularly if profit-sharing levels are reduced from previous years. Second, profits may vary a great deal from year to year—resulting in windfalls and losses beyond the employees' control. Third, the payoff may be seen as too far removed from employees' efforts to serve as a strong link between better performance and higher rewards.

Employee Stock Ownership Plans (ESOPs)

A common type of profit sharing is the **employee stock ownership plan (ESOP)**. An ESOP is designed to give employees stock ownership of the organization for which they work, thereby increasing their commitment, loyalty, and effort. According to the National Center for Employee Ownership, an estimated 15,000 firms in the United States have established broad employee-ownership programs. Of these firms, about 10,000 have formed ESOPs, covering about 9 million workers.²⁹

Employee stock ownership plan (ESOP)

A plan whereby employees gain stock ownership in the organization for which they work.

ESTABLISHING AN ESOP An organization establishes an ESOP by using its stock as collateral to borrow capital from a financial institution. Once the loan repayment begins through the use of company profits, a certain amount of stock is released and allocated to an employee stock ownership trust (ESOT). Employees are assigned shares of company stock kept in the trust, based on length of service and pay level. On retirement, death, or separation from the organization, employees or their beneficiaries can sell the stock back to the trust or on the open market, if the stock is publicly traded.

Employee stock ownership plans are subject to certain tax laws. Generally, the employers who have treated all employees alike are most advantaged. Those that provide different levels of benefits for different groups of employees are penalized in the tax laws.

ADVANTAGES AND DISADVANTAGES OF ESOPS Establishing an ESOP creates several advantages. The major one is that the firm can receive favorable tax treatment of the earnings earmarked for use in the ESOP. Second, an ESOP gives employees a “piece of the action” so that they can share in the growth and profitability of their firm. As a result, employee ownership may be effective in motivating employees to be more productive and focused on organizational performance. In one survey of over 1,100 ESOP companies, about 60% said productivity had increased, and 68% said financial performance was higher since converting to an ESOP.³⁰

Almost everyone loves the concept of employee ownership as a kind of “people’s capitalism.” However, the sharing also can be a disadvantage because employees may feel “forced” to join, thus placing their financial future at greater risk. Both their wages or salaries and their retirement benefits depend on the performance of the organization. This concentration is even riskier for retirees because the value of pension fund assets also depends on how well the company does.

Another drawback is that ESOPs have been used as a management tool to fend off unfriendly takeover attempts. Holders of employee-owned stock often align with management to turn down bids that would benefit outside stockholders but would replace management and restructure operations. Surely, ESOPs were not

created to entrench inefficient management. Despite these disadvantages, ESOPs have grown in popularity.

FASB RULES ON ESOPs Perhaps in part because of the increase in popularity of ESOPs, companies have been required to disclose how much they would have earned if the stock options they gave employees had been charged against company income. The Financial Accounting Standards Board (FASB) now requires companies to report the value of the stock options they give employees—but there is some real controversy over how to value the options.

Executive Compensation

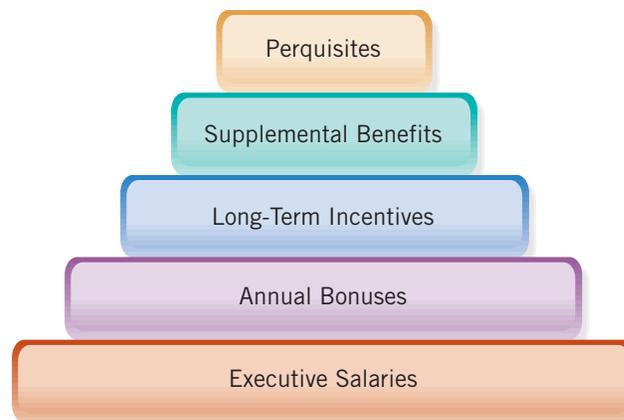
Many organizations, especially large ones, administer executive compensation somewhat differently than compensation for lower-level employees. An executive typically is someone in the top two levels of an organization, such as Chief Executive Officer (CEO), President, or Senior Vice-President. As Figure 14–10 shows, the common components of executive compensation are *salaries*, *annual bonuses*, *long-term incentives*, *supplemental benefits*, and *perquisites*.

Two objectives influence executive compensation: (1) ensuring that the total compensation packages for executives are competitive with the compensation packages in other firms that might employ them, and (2) tying the overall performance of the organization over a period of time to the compensation that is paid to executives. It is the second objective that critics of executive compensation believe is not being met. In many organizations, it appears that the levels of executive compensation may be unreasonable and not linked closely to organizational performance.

Elements of Executive Compensation

At the heart of most executive compensation plans is the idea that executives should be rewarded if the organization grows in profitability and value over a

FIGURE 14–10 *Executive Compensation Components*



period of years. Because many executives are in high tax brackets, their compensation often is provided in ways that offer significant tax savings. Therefore, their total compensation packages are more significant than their base pay. Especially when the base salary is \$1 million or more, the executive often is interested in the mix of items in the total package, including current and deferred compensation.

EXECUTIVE SALARIES Salaries of executives vary by type of job, size of organization, region of the country, and industry. On average, salaries make up about 40–60% of the typical top executive’s annual compensation total. A provision of a 1993 tax act prohibits a publicly traded company from deducting pay of more than \$1 million for each of its top five officers unless that pay is based on performance criteria approved by outside directors and shareholders.

EXECUTIVE BONUS PLANS Because executive performance may be difficult to determine, bonus compensation must reflect some kind of performance measure if it is to be meaningful. As an example, a retail chain with over 250 stores ties annual bonuses for managers to store profitability. The bonuses have amounted to as much as 35% of a store manager’s base salary.

Bonuses for executives can be determined in several ways. A discretionary system whereby bonuses are awarded based on the judgments of the chief executive officer and the board of directors is one way. However, the absence of formal, measurable targets is a major drawback of this approach. Also, as noted, bonuses can be tied to specific measures, such as return on investment, earnings per share, or net profits before taxes. More complex systems create bonus pools and thresholds above which bonuses are computed. Whatever method is used, it is important to describe it so that executives trying to earn bonuses understand the plan; otherwise, the incentive effect will be diminished.

PERFORMANCE INCENTIVES—LONG TERM VS. SHORT TERM Performance-based incentives attempt to tie executive compensation to the long-term growth and success of the organization. However, whether the emphasis is really on the long term or merely represents a series of short-term rewards is controversial. Short-term rewards based on quarterly or annual performance may not result in the kind of long-run-oriented decisions necessary for the company to continue to do well.

A **stock option** gives an individual the right to buy stock in a company, usually at an advantageous price. Different types of stock options have been used depending on the tax laws in effect. Stock options have increased in use as a component of executive compensation during the past 10 years, and employers may use a variety of very specialized and technical approaches to them, which are beyond the scope of this discussion. However, the overall trend is toward using stock options as performance-based long-term incentives.

Where stock is closely held, firms may grant “stock equivalencies” in the form of *phantom stock* or *share appreciation rights*. These plans pay recipients the increased value of the stock in the future, determined by a base valuation made at the time the phantom stock or share appreciation rights are given. Depending on how these plans are established, the executives may be able to defer taxes or be taxed at lower capital-gains tax rates.

BENEFITS FOR EXECUTIVES As with benefits for non-executive employees, executive benefits may take several forms, including traditional retirement, health



LOGGING ON . . .

Crystal Report

The Crystal Report evaluates executive compensation levels and issues.

Details on the report can be found at

www.crystalreport.com.

Stock option

A plan that gives an individual the right to buy stock in a company, usually at a fixed price for a period of time.

insurance, vacations, and others. However, executive benefits may include some items that other employees do not receive. For example, executive health plans with no co-payments and with no limitations on deductibles or physician choice are popular among small and middle-sized businesses. Corporate-owned life insurance on the life of the executive is popular and pays *both* the executive's estate *and* the company in the event of death. Trusts of various kinds may be designed by the company to help the executive deal with estate issues. Deferred compensation is another possible means used to help executives with tax liabilities caused by incentive compensation plans.

Perquisites (perks)

Special benefits—usually noncash items—for executives.

EXECUTIVE PERQUISITES In addition to the regular benefits received by all employees, executives often receive benefits called perquisites. **Perquisites (perks)** are special executive benefits—usually noncash items. Perks are useful in tying executives to organizations and in demonstrating their importance to the companies. It is the status enhancement value of perks that is important to many executives. Visible symbols of status allow executives to be seen as “very important people (VIPs)” both inside and outside their organizations. In addition, perks can offer substantial tax savings because many perks are not taxed as income. Figure 14–11 on the next page lists some perks that are commonly available.

Board of Directors' Role with Executive Compensation

In most organizations the board of directors is the major policy-setting entity. For publicly traded companies covered by federal regulatory agencies, such as the Securities and Exchange Commission (SEC), the board of directors must approve executive compensation packages. Even many nonprofit organizations are covered by Internal Revenue Service requirements to have boards of directors review and approve the compensation for top-level executives. In family-owned or privately owned firms, boards of directors may have less involvement in establishing and reviewing the compensation packages for key executives.

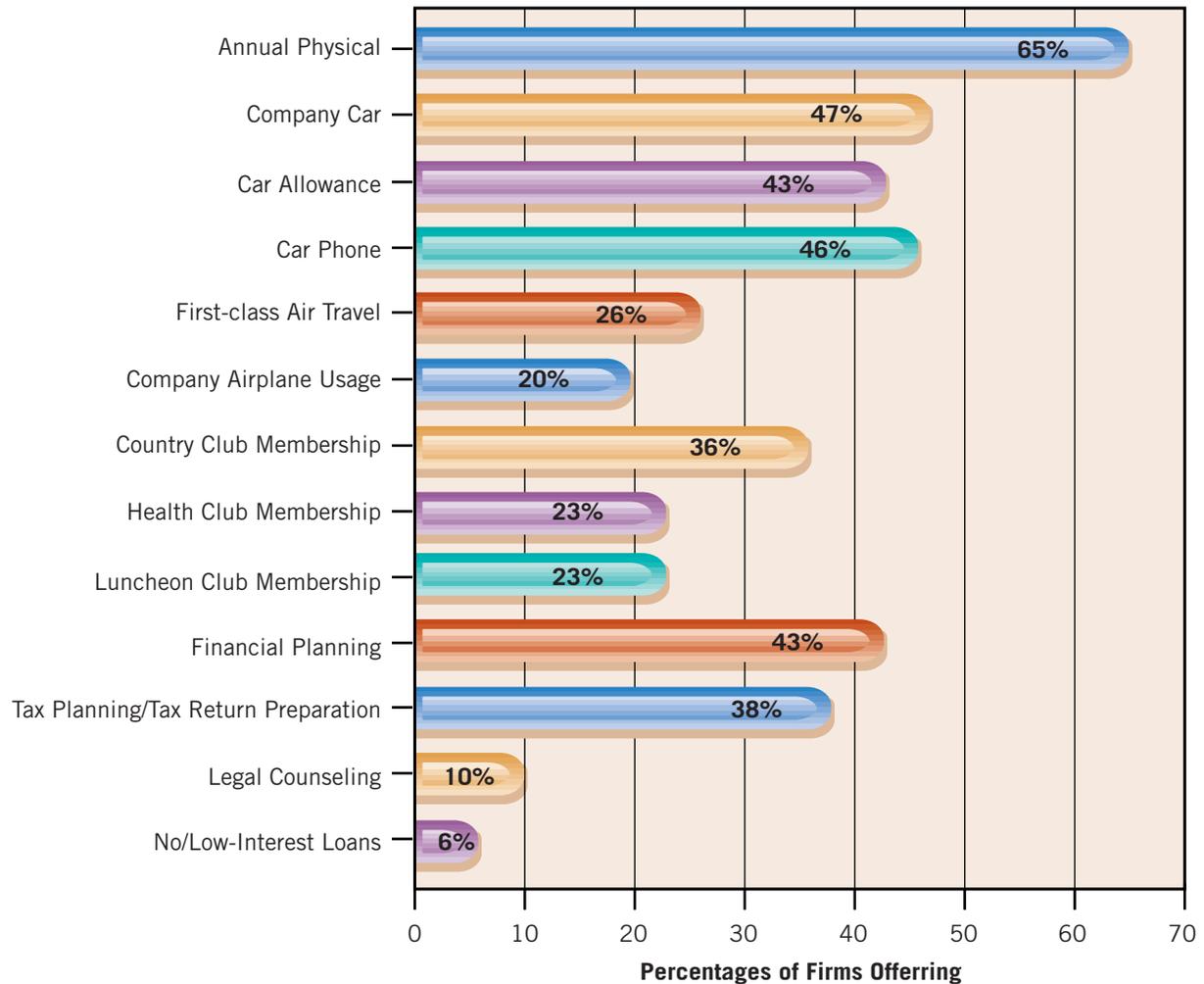
Compensation committee

Usually a subgroup of the board of directors composed of directors who are not officers of the firm.

BOARD COMPENSATION COMMITTEE The **compensation committee** usually is a subgroup of the board of directors composed of directors who are not officers of the firm. Compensation committees generally make recommendations to the board of directors on overall pay policies, salaries for top officers, supplemental compensation such as stock options and bonuses, and additional perquisites (“perks”) for executives. But the “independence” of board compensation committees increasingly has been criticized.³¹

One major concern voiced by many critics is that the base pay and bonuses of CEOs often are set by board compensation members, many of whom are CEOs of other companies with similar compensation packages. However, one study found little relationship between the composition of compensation committees of boards and the level of CEO compensation.³² Also, the compensation advisors and consultants to the CEOs often collect large fees, and critics charge that those fees distort the objectivity of the advice given.

To counter criticism, some corporations are changing the composition of the compensation committee and giving it more independence. Some of the changes include prohibiting “insider” company officers and board members from serving on compensation committees. Also, some firms empower the compensation committee to hire and pay compensation consultants without involving executive management.

FIGURE 14–11 *Executive Perquisites*

*Percentages based on 767 total responses.

SOURCE: Based on data in *1998 Executive Compensation Survey* (Louisville, KY: William M. Mercer, Inc., 1998), 11.

More importantly, the link between the independence of board compensation committees and organization performances is crucial. If the compensation committee's decisions about executive variable pay lead to higher organizational performance, then the composition of the compensation committee is less of an issue. Research on compensation committees and organizational performance indicates that having more "outside" directors is linked to better organizational performance results, as the HR Perspective on the next page indicates.

BOARD MEMBERS' COMPENSATION Although they are not executives of the firm, outside members of boards of directors receive compensation as well. Generally, they receive directors' fees, either as a set amount per year or a per-meeting fee. To counter some criticisms of the independence of board members,

HR PERSPECTIVE

Research on Board Compensation Committees and Organizational Performance

There has been a growing debate about how the composition of the compensation committees of corporate boards of directors affects executive compensation. One study that gathered research on this area was published in the *Academy of Management Journal*.

The study by Conyon and Peck examined performance data on publicly traded firms in the United Kingdom (U.K.) and compared those results to the composition of board compensation committees. Data were collected from the top 100 companies in market value in the U.K. Details on composite perfor-

mance, organization size, and corporate governance were gathered by the researchers. Data on a total of 94 companies were used in the study. The researchers examined the proportion of “outside” directors and the existence of board compensation committees. Another factor examined was whether the corporate CEOs also served as the Chairman of the board of directors.

The researchers concluded that top management pay was more aligned with corporate performance in companies with a greater number of “outsiders” and use of a compensation committee to make executive

compensation decisions. The results of this study suggest that outsiders do play a role in ensuring that executive incentives are linked more closely to organizational results. Also, having a higher proportion of outsiders on board compensation committees seemed to be related to even higher performance. The authors conclude by stating, “The evidence appears to clearly indicate that the composition of both a company’s main board and its compensation committee are important in the closer alignment of management pay and corporate performance.”³³

some experts have recommended that board members be paid totally or in part with company stock. This approach is seen as linking board members’ pay more closely to that of the stockholders they represent. Also, some corporations require board members to purchase and own a minimum number of shares of stock in the company.

Reasonableness of Executive Compensation

The expansion of executive compensation to include significant stock options and other components may be necessary for firms to be competitive for top executive talent, especially in larger, publicly traded corporations.³⁴ The purpose of including the stock and other components is to link organizational performance to executive compensation.

ORGANIZATIONAL PERFORMANCE AND EXECUTIVE COMPENSATION Whether executive compensation levels are linked to organizational performance has been the subject of numerous studies. One key in evaluating all of the studies is to examine the performance measures used. In many settings, financial measures such as return on equity, return to shareholders, earnings per share, net income before taxes, and other criteria are used. However, a number of firms also incorporate nonfinancial organizational measures of performance when determining executive bonuses and incentives. Customer satisfaction, employee satisfaction, market share, productivity, quality, and other areas are measured and considered when executive performance rewards are given.³⁵

HR PERSPECTIVE

Ethics of Huge Golden Parachutes

“Out of control,” “obscene,” “sickening,” “outrageous and irresponsible.” No, these comments are not being made about toxic waste or organized crime. Instead, they are comments made about golden parachutes received by individuals who had been Chief Executive Officers (CEOs) of corporations during the past few years. Some examples include the following:

- Michael Ovitz served as the second highest executive at Walt Disney for about a year. When he quit, he received a golden parachute estimated to be as high as \$90 million! The reason for his departure was incompatibility with Michael Eisner, CEO of Disney.
- When Tandem Computers was acquired by Compaq, Roel Pieper got a parachute paying him \$6 million plus options on company shares worth over \$10 million.

These rewards were given, despite Tandem’s corporate performance being mediocre for several years before the acquisition.

- When Union Pacific Corp (UP) acquired Southern Pacific Railroad, the CEO of UP, Drew Lewis, got a \$4 million bonus and a five-year consulting contract paying \$3.75 million. Unfortunately, the merger was handled badly for a few years, resulting in rail traffic delays, safety problems, and a significant decline in the financial results of the combined companies.

Critics of these and other large golden parachutes for a few top executives point out that these parachutes were suggested and pushed by the executives who were to receive them. Despite these parachutes being approved by boards of directors, critics also question how independent the board decisions

really are, given the fact that the CEOs and other senior executives serve on those same boards.

Just as troubling, these golden parachutes go to only a few people, whereas the numerous employees who lose their jobs after mergers and acquisitions receive limited or no parachute protection. Finally, golden parachutes are often given to top executives who have presided over firms whose performance has been mediocre to poor. Thus, a few executives get rewarded, even though corporate performance has not produced returns to stockholders. Despite the criticisms of golden parachutes, financial experts are projecting that the increasing number of mergers and consolidations in many industries will lead to even more outlandish golden parachutes being given to a limited number of executives.⁴¹

Golden parachute

A severance benefit that provides protection and security to executives in the event that they lose their jobs or that their firms are acquired by other firms.

Silver parachute

A severance and benefits plan to protect nonexecutives if their firms are acquired by other firms.

“GOLDEN PARACHUTES” FOR EXECUTIVES A special perk available to some executives, a **golden parachute**, provides protection and security to executives in the event that they lose their jobs or their firms are acquired by other firms. Typically, employment contracts are written to give special compensation to executives if they are negatively affected in an acquisition or merger.

Estimates are that over half of all CEOs and other senior executives in the largest major corporations have golden parachutes. A typical golden parachute gives a CEO a lump sum amount equal to 2–4 times their annual salary and bonus, extra pension credits, immediate vesting of stock options, outplacement assistance, and other sweeteners. Additionally, some golden parachutes provide consulting contracts of up to 10 years at the final annual salary and bonus.⁴⁰ But the huge size of some parachute packages raises some ethical concerns, as the HR Perspective discusses.

There are a number of criticisms of golden parachutes. First, golden parachutes often are criticized for giving executives protection, while lower- and middle-level managers and other employees are left vulnerable when mergers or acquisitions occur. As a result, some firms have established **silver parachutes**, severance and benefit plans to protect nonexecutives if their firms are acquired

by other firms. For example, one manufacturer has a generous severance pay and benefits plan that goes into effect if a hostile takeover threatens any of the 3,500 employees' jobs. Whether golden or silver, the parachute phenomenon is a clear response to the takeover strategy that many organizations have faced.

Another problem with golden parachutes is that many parachute provisions are not tied to organizational performance. One study of the banking industry found that adoption of golden parachutes for top executives was correlated with poor bank operating performance, both before and after the adoption of the parachutes.⁴²

Additionally, there are indications that executives push boards to adopt golden parachutes in order to deter takeover attempts.⁴³ In this way the executives, particularly those in underperforming organizations, can continue in their jobs—for which they receive extensive compensation.

Another criticism of executive compensation is that a short-term focus of one year is used in some executive compensation packages. Instead, performance in a given year may lead to large rewards even though corporate performance over a multi-year period may be mediocre. This difference is especially apparent if the yearly measures are carefully chosen. Executives can even manipulate earnings per share by selling assets, liquidating inventories, or reducing research and development expenditures. All these actions may make organizational performance look better, but they may impair the long-term growth of the organization.

Overall, the reasonableness of executive compensation is often justified by comparison to compensation market surveys, but these surveys usually provide a range of compensation data that requires interpretation. A tax court case suggested some interesting criteria to determine if executive pay was “reasonable” in a specific instance.⁴⁴

- Would another company hire this person as CEO?
- Is the company so tenuous that a premium must be paid?
- How does this compensation compare with that in similar companies?
- Is the CEO's pay consistent with pay for the other employees?
- What would an investor pay for this CEO's level of performance?

Undoubtedly, the criticisms of executive compensation will continue as huge payouts occur, particularly if organizational performance has been weak. Hopefully, boards of directors of more corporations will address the need to better link organizational performance with variable pay rewards for executives and other employees.

Summary

- Variable pay is additional compensation linked to individual, team (group), and/or organizational performance. Variable pay traditionally has been referred to as incentives.
- Effective variable pay plans should recognize organizational culture and resources, be clear and understandable, be kept current, tie incentives to performance, recognize individual differences, and identify plan payments separate from base pay.
- Sales employees may have their compensation tied to their performance on a number of sales-related criteria. Sales compensation can be provided as salary only, commission only, and salary plus commissions or bonuses.
- Design of team (group) variable pay plans must consider how team incentives are to be distributed, the timing of the incentive payments, and how decisions are made about who receives how much of the variable payout.

- To overcome some problems associated with individual incentives, team (group) variable pay plans encourage and reward teamwork and group effort.
- One prominent organization-wide variable pay plan is gainsharing, which provides rewards based on greater-than-expected gains in profits and/or productivity.
- Other organization-wide incentive plans include Improshare, Scanlon, and Rucker plans.
- Profit-sharing plans set aside a portion of the profits earned by organizations for distribution to employees.
- An employee stock ownership plan (ESOP) enables employees to gain ownership in the firm for which they work.
- Executive compensation must be viewed as a total package composed of salaries, bonuses, long-term performance-based incentives, benefits, and perquisites (perks).
- A compensation committee, which is a subgroup of the board of directors, has authority over executive compensation plans.
- Performance-based incentives often represent a significant portion of an executive's compensation package. Stock options, phantom stock, and stock appreciation rights are widely used.
- Perks provide additional noncash compensation to executives.

Review and Discussion Questions

1. Identify what variable pay is and discuss why its usage has increased.
2. Describe why incentive plans you have received at work have been successful and/or unsuccessful.
3. Give several examples of individual incentives that have been used by an organization in which you were employed.
4. What are the positives and negatives associated with using salary-only and commission-only sales compensation plans?
5. Describe situations in which team incentive plans are likely to be successful.
6. Why would an employee stock ownership plan (ESOP) be seen by employees both as an attraction and as a risk?
7. Locate a corporate annual report and review it to identify the components of executive compensation discussed in it. How reasonable is the compensation of the CEO compared with the corporate results described in the report?

Terms to Know

bonus 464	employee stock ownership plan (ESOP) 477	profit sharing 476
commission 469	gainsharing 474	silver parachute 484
compensation committee 480	golden parachute 484	stock option 479
differential piece-rate system 464	perquisites (perks) 480	straight piece-rate system 463
draw 470		variable pay 458

Using the Internet



Executive Compensation Issues

The board of directors has asked you, as HR Director, to research some issues on CEO compensation. The board and some of the stockholders have expressed some concerns about the compensation plan for the CEO. They are not sure if it is justified, or if it is the

market rate for a CEO. Using the following website, research six reasons why a large compensation plan for the CEO may not be justified.

<http://aflcio.org/paywatch/problem/index.htm>

CASE

County Governments and Incentive Programs

The spread of incentive programs is not limited to private-sector employers. A number of local and state governmental entities have established incentive programs, including public school districts, state-operated institutions, and county governments. Two county government programs illustrate both the advantages and the reactions to the use of incentives in the public sector.

In Maryland several years ago, Baltimore County employee morale was very low, and for good reason. Over the previous five years, employees had received raises in only one of the years, the number of employees had declined, and some layoffs had occurred. During the same period of time the population in Baltimore County had increased significantly, which meant more work for fewer workers who had received limited pay increases. Also, the quality of the services delivered by the county employees had declined somewhat.

Then changes began to be made when a new county executive, Dutch Ruppensberger, took office. Ruppensberger, who previously had served on the council, recruited outside consultants to help design an employee gainsharing program. Ruppensberger saw this program as a way to improve quality and productivity in delivering county services while also rewarding employees for their efforts. The program began by gathering employee ideas and obtaining employee input through some employee teams. Then a pilot program was begun in two very different divisions, Dietary Services and Recreational and Parks Maintenance. Employees in the two divisions participated in training on teamwork and resolving conflicts. Then the teams met to draft program objectives and action plans. The Dietary Services Division, which provided meals to prisoners in the county jails, identified potential savings of \$88,000 that could be made. The Recreation and Parks Maintenance employees estimated that savings of \$126,000 could be reached. Both divisions submitted their plans to county management and then the County Council. With approvals granted, the gainsharing program was implemented. Under the plan half of the estimated savings in each division go to the county, while the

other half of the savings are divided equally among participating division employees up to an identified maximum amount. Based upon the first year of the plan in these two divisions, significant savings have been obtained, and participating employees received their appropriate payments. The success of programs at Baltimore County appears to be due to its focus on rewarding employees directly involved in delivering county services.

However, a bonus incentive plan for executive-level managers in San Diego County in California created a firestorm of controversy. Under the San Diego County plan, executive-level, across-the-board pay increases were eliminated. Performance bonuses were paid only to executives who attained established performance objectives. A total of 180 executives and administrators received bonus payments totaling \$1.34 million; but one-third of all executives received no bonus, and several had their base pay cut because of missing performance objectives.

When the amounts of the bonuses were made public, a furor resulted. The local union representing lower-paid county employees protested that executives—including the top county executive, who got a \$45,000 bonus—were getting huge sums, while lower-level employees got only a 3% raise. Further, the union noted that some of the bonus amounts were more than the annual income of many lower-level county employees. Also, the bonus program for executives cost \$500,000 more than if 3% across-the-board raises had been given to those executives. As a result of the controversy, the county board directed that the program be revised.⁴⁵

Questions

1. What factors determined the success and failure of the two programs described in the case?
2. Given the strength of public-sector unions, some experts believe that incentive programs in public-sector organizations will never become widespread. Comment on this view and discuss why it may or may not prevail.

Notes

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