chapter

12

Recognizing Employee Contributions with Pay

What Do I Need to Know?

After reading this chapter, you should be able to:

LO1 Discuss the connection between incentive pay and employee performance.

LO2 Describe how organizations recognize individual performance.

LO3 Identify ways to recognize group performance.

LO4 Explain how organizations link pay to their overall performance.

LO5 Describe how organizations combine incentive plans in a "balanced scorecard."

LO6 Summarize processes that can contribute to the success of incentive programs.

LO7 Discuss issues related to performance-based pay for executives.

Introduction

The 7,500 employees of Jamba Juice Company know how to earn more money. They know that their pay raises depend on how well they performed their jobs the previous year. Supervisors rank employees according to whether their performance was outstanding, above requirements, meeting requirements, or below requirements. Those in the top category receive the largest raises. Those rated as performing below requirements receive no raise at all, and they don't have a chance to earn a bonus. According to Russ Testa, Jamba Juice's vice president of human resources, this pay system is a practical matter of allocating the company's money to the company's best employees: "If you're devoting dollars to underperformers, that simply means you're taking away from your high performers."[1] Employees consider the process fair because they understand how their performance will be measured and how it will affect their pay.

The pay earned by each Jamba Juice employee depends on the starting pay for a particular job (the topic of the preceding chapter) and pay raises tied to the employee's performance. In this chapter we focus on using pay to recognize and reward employees' contributions to the organization's success. Employees' pay does not depend solely on the jobs they hold. Instead, organizations vary the amount paid according to differences in performance of the individual, group, or whole organization, as well as differences in employee qualities such as seniority and skills.[2]

Incentive Pay
Forms of pay linked to an employee's performance as an individual, group member, or organization member.

In contrast to decisions about pay structure, organizations have wide discretion in setting performance-related pay, called **incentive pay.** Organizations can tie incentive pay to individual performance, profits, or many other measures of success. They select incentives based on their costs, expected influence on performance, and fit with the organization's broader HR and company policies and goals. These decisions are significant. A study of 150 organizations found that the way organizations paid employees was strongly associated with their level of profitability.[3]

This chapter explores the choices available to organizations with regard to incentive pay. First, the chapter describes the link between pay and employee performance. Next, we discuss ways organizations provide a variety of pay incentives to individuals. The following two sections describe pay related to group and organizational performance. We then explore the organization's processes that can support the use of incentive pay. Finally, we discuss incentive pay for the organization's executives.

LO1 Discuss the connection between incentive pay and employee performance.

Incentive Pay

Along with wages and salaries, many organizations offer *incentive pay*—that is, pay specifically designed to energize, direct, or control employees' behavior. Incentive pay is influential because the amount paid is linked to certain predefined behaviors or outcomes. For example, as we will see in this chapter, an organization can pay a salesperson a *commission* for closing a sale, or the members of a production department can earn a *bonus* for meeting a monthly production goal. Usually, these payments are in addition to wages and salaries. Knowing they can earn extra money for closing sales or meeting departmental goals, the employees often try harder or get more creative than they might without the incentive pay. In addition, the policy of offering higher pay for higher performance may make an organization attractive to high performers when it is trying to recruit and retain these valuable employees.[4] For reasons such as these, the share of companies offering variable pay rose in less than two decades from about half of companies to 9 out of 10.[5]

For incentive pay to motivate employees to contribute to the organization's success, the pay plans must be well designed. In particular, effective plans meet the following requirements:

- Performance measures are linked to the organization's goals.
- Employees believe they can meet performance standards.
- The organization gives employees the resources they need to meet their goals.
- Employees value the rewards given.
- Employees believe the reward system is fair.
- The pay plan takes into account that employees may ignore any goals that are not rewarded.

The "HR How To" box provides some additional ideas for creating and implementing an effective incentive-pay plan even when resources are limited.

Since incentive pay is linked to particular outcomes or behaviors, the organization is encouraging employees to demonstrate those chosen outcomes and behaviors. As obvious as that may sound, the implications are more complicated. If incentive pay is extremely rewarding, employees may focus on only the performance measures rewarded under the plan and ignore measures that are not rewarded. Suppose an organization pays managers a bonus when employees are satisfied; this policy may interfere with other management goals. A manager who doesn't quite know how to inspire employees to do their best might be tempted to fall back on overly positive performance

HR How To

STRETCHING INCENTIVE-PAY DOLLARS

One advantage of incentive pay is that, because it is targeted to reinforcing desired behaviors and outcomes, there are ways to get a lot of benefits out of it even when budgets are tight. Here are some ideas for getting the most out of an incentive-pay plan:

- Be very clear about what behavior or outcomes you want to encourage. Many options are available, from delighting customers to preventing accidents to selling the products that have the biggest profit margins. Direct most or all of the incentive pay to rewarding performance on the measurements that will have the most impact on the organization's success.
- Set up objective ways to measure whether the individual or group earns the incentive, so that rewards don't become a popularity contest or lottery. The measurement should include a minimum level of performance required for receiving part or all of the reward.
- Communicate with employees. Especially if money is tight, be honest about the company's resources. Invite ideas about what employees would appreciate receiving, so that you'll be spending on what matters most.
- Combine the forms of incentive pay with nonmonetary rewards such as thank-you notes and public recognition for group and individual accomplishments. In some cases, employees may be wowed by a chance to have breakfast with the boss or attend a meeting with a company expert.
- When delivering the reward, communicate what accomplishment led to the award, so employees see the connection—and that they see that the company also notices what they have contributed.
- Consider giving managers a pool of money to use for granting bonuses when individuals or groups exhibit the desired performance or exceed objectives.
- Grant bonuses or other incentives frequently. Smaller payouts delivered more frequently can keep excitement higher for the same amount of money as the organization would have spent on an annual bonus.

Sources: "How to Reward Employees on a Budget," *Inc.*, April 19, 2010, www.inc.com; and "Try Two Bonus Tactics Suited for Tough Times," *HR Specialist: Compensation & Benefits*, March 2010, Business & Company Resource Center, http://galenet.galegroup.com.

appraisals, letting work slide to keep everyone happy. Similarly, many call centers pay employees based on how many calls they handle, as an incentive to work quickly and efficiently. However, speedy call handling does not necessarily foster good customer relationships. As we will see in this chapter, organizations may combine a number of incentives so employees do not focus on one measure to the exclusion of others.

Attitudes that influence the success of incentive pay include whether employees value the rewards and think the pay plan is fair. Some observers of today's workplace have found that young workers typically want frequent encouragement, and creative managers have developed incentives that get this type of worker excited. A beverage wholesaler, for example, began awarding its employees "points." For every routine and extra task involved in running the warehouse, employees earn points, and those points can be exchanged for extra pay or time off. Employees see a connection between hard work and immediate rewards (points), so they work harder. Similarly, a manager of an ad agency discovered that a young employee was so delighted to learn she had been awarded "extra points" for going above and beyond her usual duties that the agency began awarding points to all employees for beating deadlines and turning in exceptional work. The agency counts up the points and converts them into bonus pay.[6]

Although most, if not all, employees value pay, it is important to remember that earning money is not the only reason people try to do a good job. As we discuss in other chapters (see Chapters 4, 8, and 13), people also want interesting work, appreciation for their efforts, flexibility, and a sense of belonging to the work group—not to mention the inner satisfaction of work well done. Therefore, a complete plan for motivating and compensating employees has many components, from pay to work design to developing managers so they can exercise positive leadership.

With regard to the fairness of incentive pay, the preceding chapter described equity theory, which explains how employees form judgments about the fairness of a pay structure. The same process applies to judgments about incentive pay. In general, employees compare their efforts and rewards with other employees', considering a plan to be fair when the rewards are distributed according to what the employees contribute.

The remainder of this chapter identifies elements of incentive pay systems. We consider each option's strengths and limitations with regard to these principles. The many kinds of incentive pay fall into three broad categories: incentives linked to individual, group, or organizational performance. Choices from these categories should consider not only their strengths and weaknesses, but also their fit with the organization's goals. The choice of incentive pay may affect not only the level of motivation but also the kinds of employees who are attracted to and stay with the organization. For example, there is some evidence that organizations with team-based rewards will tend to attract employees who are more team-oriented, while rewards tied to individual performance make an organization more attractive to those who think and act independently, as individuals.[7] Given the potential impact, organizations not only should weigh the strengths and weaknesses in selecting types of incentive pay but also should measure the results of these programs (see "Did You Know?").

LO2 Describe how organizations recognize individual performance.

Pay for Individual Performance

Organizations may reward individual performance with a variety of incentives:

- Piecework rates
- Standard hour plans
- Merit pay
- Individual bonuses
- Sales commissions

Piecework Rates

Piecework Rate
A wage based on the amount workers produce.

Straight Piecework Plan
Incentive pay in which the employer pays the same rate per piece, no matter how much the worker produces.

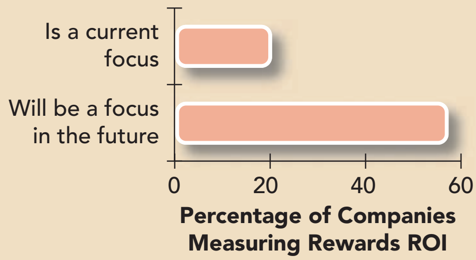
As an incentive to work efficiently, some organizations pay production workers a **piecework rate,** a wage based on the amount they produce. The amount paid per unit is set at a level that rewards employees for above-average production volume. For example, suppose that on average, assemblers can finish 10 components in an hour. If the organization wants to pay its average assemblers $8 per hour, it can pay a piecework rate of $8/hour divided by 10 components/hour, or $.80 per component. An assembler who produces the average of 10 components per hour earns an amount equal to $8 per hour. An assembler who produces 12 components in an hour would earn $.80 × 12, or $9.60 each hour. This is an example of a **straight piecework plan,** because the employer pays the same rate per piece, no matter how much the worker produces.

Did You Know?

Investing in Human Resources

In a recent survey of more than 750 organizations in 66 countries, only one out of five said they measure the return on investment (ROI) of incentive programs, but more want to move in that direction. Companies that measure the ROI of rewards tend to think of pay as an investment in human resources aimed at bringing out top performance. Companies that don't measure ROI typically think of pay as simply a cost of doing business.

Source: Tom McMullen, *Reward Next Practices* (Hay Group, August 2009), http://www.haygroup.com.



A variation on straight piecework is **differential piece rates** (also called *rising* and *falling differentials*), in which the piece rate depends on the amount produced. If the worker produces more than the standard output, the piece rate is higher. If the worker produces at or below the standard, the amount paid per piece is lower. In the preceding example, the differential piece rate could be $1 per component for components exceeding 12 per hour and $.80 per component for up to 12 components per hour.

Differential Piece Rates
Incentive pay in which the piece rate is higher when a greater amount is produced.

In one study, the use of piece rates increased production output by 30 percent—more than any other motivational device evaluated.[8] An obvious advantage of piece rates is the direct link between how much work the employee does and the amount the employee earns. This type of pay is easy to understand and seems fair to many people, if they think the production standard is reasonable. In spite of their advantages, piece rates are relatively rare for several reasons.[9] Most jobs, including those of managers, have no physical output, so it is hard to develop an appropriate performance measure. This type of incentive is most suited for very routine, standardized jobs with output that is easy to measure. For complex jobs or jobs with hard-to-measure outputs, piecework plans do not apply very well. Also, unless a plan is well designed to include performance standards, it may not reward employees for focusing on quality or customer satisfaction if it interferes with the day's output. In Figure 12.1, the employees quickly realize they can earn huge bonuses by writing software "bugs" and then fixing them, while writing bug-free software affords no chance to earn bonuses. More seriously, a bonus based on number of faucets produced gives production workers no incentive to stop a manufacturing line to correct a quality-control problem. Production-oriented goals may do nothing to encourage employees to learn new skills or cooperate with others. Therefore, individual incentives such as these may be a poor incentive in an organization that wants to encourage teamwork. They may not be helpful in an organization with complex jobs, employee empowerment, and team-based problem solving.

Figure 12.1

How Incentives Sometimes "Work"

SOURCE: DILBERT: © Scott Adams/Dist. By United Feature Syndicate, Inc.

Standard Hour Plans

Standard Hour Plan
An incentive plan that pays workers extra for work done in less than a preset "standard time."

Another quantity-oriented incentive for production workers is the **standard hour plan,** an incentive plan that pays workers extra for work done in less than a preset "standard time." The organization determines a standard time to complete a task, such as tuning up a car engine. If the mechanic completes the work in less than the standard time, the mechanic receives an amount of pay equal to the wage for the full standard time. Suppose the standard time for tuning up an engine is 2 hours. If the mechanic finishes a tune-up in 1½ hours, the mechanic earns 2 hours' worth of pay in 1½ hours. Working that fast over the course of a week could add significantly to the mechanic's pay.

In terms of their pros and cons, standard hour plans are much like piecework plans. They encourage employees to work as fast as they can, but not necessarily to care about quality or customer service. Also, they only succeed if employees want the extra money more than they want to work at a pace that feels comfortable.

Merit Pay

Merit Pay
A system of linking pay increases to ratings on performance appraisals.

Almost all organizations have established some program of **merit pay**—a system of linking pay increases to ratings on performance appraisals. (Chapter 8 described the content and use of performance appraisals.) To make the merit increases consistent, so they will be seen as fair, many merit pay programs use a *merit increase grid,* such as the sample for Merck, the giant drug company, in Table 12.1. As the table shows, the decisions about merit pay are based on two factors: the individual's performance rating and the individual's compa-ratio (pay relative to average pay, as defined in Chapter 11). This system gives the biggest pay increases to the best performers and to those whose pay is relatively low for their job. At the highest extreme, an exceptional employee earning 80 percent of the average pay for his job could receive a 15 percent merit raise. An employee rated as having "room for improvement" would receive a raise only if that employee was earning relatively low pay for the job (compa-ratio of .95 or less).

By today's standards, all of these raises are large, because they were created at a time when inflation was strong and economic forces demanded big pay increases to keep up with the cost of living. The range of percentages for a policy used today would be lower. Organizations establish and revise merit increase grids in light of changing economic conditions. When organizations revise pay ranges, employees have new compa-ratios. A higher pay range would result in lower compa-ratios, causing employees to

Table 12.1

Sample Merit Increase Grid

PERFORMANCE RATING		SUGGESTED MERIT INCREASE PERCENTAGE COMPA-RATIO 80.00–95.00	COMPA-RATIO 95.01–110.00	COMPA-RATIO 110.01–120.00	COMPA-RATIO 120.01–125.00
EX	(Exceptional within Merck)	13–15%	12–14%	9–11%	To maximum of range
WD	(Merck Standard with Distinction)	9–11	8–10	7–9	—
HS	(High Merck Standard)	7–9	6–8	—	—
RI	(Merck Standard Room for Improvement)	5–7	—	—	—
NA	(Not Adequate for Merck)	—	—	—	—

SOURCE: K. J. Murphy, "Merck & Co., Inc. (B)," Boston: Harvard Business School, Case 491-006. Copyright © 1990 by the President & Fellows of Harvard College. Reprinted with permission.

become eligible for bigger merit increases. An advantage of merit pay is therefore that it makes the reward more valuable by relating it to economic conditions.

A drawback is that conditions can shrink the available range of increases. During recent years, budgets for merit pay increases were about 3 to 5 percent of pay, so average performers could receive a 4 percent raise, and top performers perhaps as much as 6 percent. The 2-percentage-point difference, after taxes and other deductions, would amount to only a few dollars a week on a salary of $40,000 per year. Over an entire career, the bigger increases for top performers can grow into a major change, but viewed on a year-by-year basis, they are not much of an incentive to excel.[10] As Figure 12.2 shows, companies typically spread merit raises fairly evenly across all employees. However, experts advise making pay increases twice as great for top performers as for average employees—and not rewarding the poor performers with a raise at all.[11] Imagine if the raises given to the bottom two categories in Figure 12.2 instead went toward 7 percent raises for the top performers. This type of decision signals that excellence is rewarded.

Figure 12.2

Ratings and Raises: Underrewarding the Best

Note: Experts advise that the top category should receive twice as much as the middle category.

Another advantage of merit pay is that it provides a method for rewarding performance in all of the dimensions measured in the organization's performance management system. If that system is appropriately designed to measure all the important job behaviors, then the merit pay is linked to the behaviors the organization desires. This link seems logical, although so far there is little research showing the effectiveness of merit pay.[12]

A drawback of merit pay, from the employer's standpoint, is that it can quickly become expensive. Managers at a majority of organizations rate most employees' performance in the top two categories (out of four or five).[13] Therefore, the majority of employees are eligible for the biggest merit increases, and their pay rises rapidly. This cost is one reason that some organizations have established guidelines about the percentage of employees that may receive the top rating, as discussed in Chapter 8. Another correction might be to use 360-degree performance feedback (discussed in Chapter 9), but so far, organizations have not used multisource data for pay decisions.[14]

Another drawback of merit pay is that it makes assumptions that may be misleading. Rewarding employees for superior performance ratings assumes that those ratings depend on employees' ability and motivation. But performance may actually depend on forces outside the employee's control, such as managers' rating biases, the level of cooperation from co-workers, or the degree to which the organization gives employees the authority, training, and resources they need. Under these conditions, employees will likely conclude that the merit pay system is unfair.

Quality guru W. Edwards Deming also criticizes merit pay for discouraging teamwork. In Deming's words, "Everyone propels himself forward, or tries to, for his own good, on his own life preserver. The organization is the loser."[15] For example, if employees in the purchasing department are evaluated based on the number or cost of contracts they negotiate, they may have little interest in the quality of the materials they buy, even when the manufacturing department is having quality problems. In reaction to such problems, Deming advocated the use of group incentives. Another alternative is for merit pay to include ratings of teamwork and cooperation. Some employers ask co-workers to provide such ratings.

Performance Bonuses

Like merit pay, performance bonuses reward individual performance, but bonuses are not rolled into base pay. The employee must re-earn them during each performance period. In some cases, the bonus is a one-time reward. Bonuses may also be linked to objective performance measures, rather than subjective ratings.

Bonuses for individual performance can be extremely effective and give the organization great flexibility in deciding what kinds of behavior to reward. Examples include the companies described in the "Best Practices" box and Continental Airlines, which pays employees a quarterly bonus for ranking in the top three airlines for on-time arrivals, a measure of service quality. In many cases, employees receive bonuses for meeting such routine targets as sales or production numbers. Such bonuses encourage hard work. But an organization that focuses on growth and innovation may get better results from rewarding employees for learning new skills than from linking bonuses to mastery of existing jobs. Similarly, bonuses make up a large part of compensation packages in the financial industry, and when that industry nearly collapsed in 2008, some observers questioned the basis for awarding the bonuses. Were investment banks, for example, really rewarding the right behaviors if bonuses were falling

Best Practices

INCENTIVES FOR INNOVATION

Some companies tie bonuses to activities that foster innovation. Two good examples come from entirely different industries: candy making and survey research.

Hammond's Candies pays workers at its Denver factory a $50 bonus for any idea they provide that succeeds in driving down costs. This idea for incentive pay occurred to the company's new owner, Andrew Schuman, after he learned that one of Hammond's popular products, ribbon snowflake candy, was the idea of a worker on the assembly line. Schuman concluded that the people who actually made and packed the candy would have the best insight into possible improvements. The production processes involve a high degree of handwork, so employees are skilled at and involved in their work. In the first year of the incentive program, the company paid out more than $500 in bonuses for ideas such as reducing breakage of candy canes with new packaging and improving the efficiency of an assembly line by adjusting a machine gear. The changes have helped the once-struggling company return to profitability.

Infosurv, a marketing research firm based in Atlanta, asks employees to offer business ideas. Once a quarter, managers pick the best business idea and award a $150 restaurant gift card to the employee who submitted that idea. Jared Heyman, Infosurv's founder, estimates that in the program's first five years, it has delivered hundreds of thousands of dollars' worth of cost savings and additional revenue. Building on this success, Infosurv added a group incentive, a challenge to the company's 15 employees to suggest 100 innovative ideas in 100 days. If they succeed, everyone will receive a $100 bonus. Given that most of the employees are research and information technology experts, the one expectation that seems certain is that great ideas will flow. The incentives add excitement and a sense of urgency to the kinds of creative thinking a company like Infosurv would need as part of its daily business.

Sources: Teri Evans, "Entrepreneurs Seek Ways to Draw Out Workers' Ideas," *Wall Street Journal*, December 21, 2009, http://online.wsj.com; Hammond's Candies, "About Us," corporate Web site, www.hammondscandies.com, accessed April 26, 2010; and Infosurv, "About Infosurv," corporate Web site, www.infosurv.com, accessed April 26, 2010.

less than 50 percent or holding steady during a period when government funds were needed to keep the companies alive?[16]

Adding to this flexibility, organizations also may motivate employees with one-time bonuses. For example, when one organization acquires another, it usually wants to retain certain valuable employees in the organization it is buying. Therefore, it is common for organizations involved in an acquisition to pay *retention bonuses*—one-time incentives paid in exchange for remaining with the company—to top managers, engineers, top-performing salespeople, and information technology specialists. When Chattem, a Chattanooga, Tennessee company that makes health and beauty products, was acquired by pharmaceutical company Sanofi-Aventis, the deal included retention bonuses for Chattem's chief executive officer, president, general counsel, and chief financial officer in exchange for them staying with the company for several more years.[17]

Sales Commissions

A variation on piece rates and bonuses is the payment of **commissions,** or pay calculated as a percentage of sales. For instance, a furniture salesperson might earn commissions equaling 6 percent times the price of the furniture the person sells during the period. Selling a $2,000 couch would add $120 to the salesperson's commissions

Commissions
Incentive pay calculated as a percentage of sales.

Many car salespeople earn a straight commission, meaning that 100% of their pay comes from commission instead of a salary. What type of individual might enjoy a job like this?

for the period. Commission rates vary tremendously from one industry and company to another. Examples reported include an average rate between 5.0 and 5.5 percent for real estate, 30 percent up to 90 percent of first year's premiums on life insurance (then dropping to as low as 4 percent in subsequent years of the policy), and 20 to 30 percent of *profits* for auto sales.[18]

Some salespeople earn a commission in addition to a base salary; others earn only commissions—a pay arrangement called a *straight commission plan*. Straight commissions are common among insurance and real estate agents and car salespeople. Other salespeople earn no commissions at all, but a straight salary. Paying most or all of a salesperson's compensation in the form of salary frees the salesperson to focus on developing customer goodwill. Paying most or all of a salesperson's compensation in the form of commissions encourages the salesperson to focus on closing sales. In this way, differences in salespeople's compensation directly influence how they spend their time, how they treat customers, and how much the organization sells.

The nature of salespeople's compensation also affects the kinds of people who will want to take and keep sales jobs with the organization. Hard-driving, ambitious, risk-taking salespeople might enjoy the potential rewards of a straight commission plan. An organization that wants salespeople to concentrate on listening to customers and building relationships might want to attract a different kind of salesperson by offering more of the pay in the form of a salary. Basing part or all of a salesperson's pay on commissions assumes that the organization wants to attract people with some willingness to take risks—probably a reasonable assumption about people whose job includes talking to strangers and encouraging them to spend money.

LO3 Identify ways to recognize group performance.

Pay for Group Performance

Employers may address the drawbacks of individual incentives by including group incentives in the organization's compensation plan. To win group incentives, employees must cooperate and share knowledge so that the entire group can meet its performance targets. Common group incentives include gainsharing, bonuses, and team awards.

Gainsharing
Group incentive program that measures improvements in productivity and effectiveness and distributes a portion of each gain to employees.

Gainsharing

Organizations that want employees to focus on efficiency may adopt a **gainsharing** program, which measures increases in productivity and effectiveness and distributes a portion of each gain to employees. For example, if a factory enjoys a productivity gain worth $30,000, half the gain might be the company's share. The other $15,000 would be distributed among the employees in the factory. Knowing that they can enjoy a financial benefit from helping the company be more productive, employees supposedly will look for ways to work more efficiently and improve the way the factory operates.

Gainsharing addresses the challenge of identifying appropriate performance measures for complex jobs. For example, how would a hospital measure the production of its nurses—in terms of satisfying patients, keeping costs down, or completing a number of tasks? Each of these measures oversimplifies the complex responsibilities involved in nursing care. Even for simpler jobs, setting acceptable standards and measuring performance can be complicated. Gainsharing frees employees to determine how to improve their own and their group's performance. It also broadens employees' focus beyond their individual interests. But in contrast to profit sharing, discussed later, it keeps the performance measures within a range of activity that most employees believe they can influence. Organizations can enhance the likelihood of a gain by providing a means for employees to share knowledge and make suggestions, as we will discuss in the last section of this chapter.

Gainsharing is most likely to succeed when organizations provide the right conditions. Among the conditions identified, the following are among the most common:[19]

- Management commitment.
- Need for change or strong commitment to continuous improvement.
- Management acceptance and encouragement of employee input.
- High levels of cooperation and interaction.
- Employment security.
- Information sharing on productivity and costs.
- Goal setting.
- Commitment of all involved parties to the process of change and improvement.
- Performance standard and calculation that employees understand and consider fair and that is closely related to managerial objectives.
- Employees who value working in groups.

A popular form of gainsharing is the **Scanlon plan,** developed in the 1930s by Joseph N. Scanlon, president of a union local at Empire Steel and Tin Plant in Mansfield, Ohio. The Scanlon plan gives employees a bonus if the ratio of labor costs to the sales value of production is below a set standard. To keep this ratio low enough to earn the bonus, workers have to keep labor costs to a minimum and produce as much as possible with that amount of labor. Figure 12.3 provides an example. In this example, the standard is a ratio of 20/100, or 20 percent, and the workers produced parts worth $1.2 million. To meet the standard, the labor costs should be less than 20 percent of $1.2 million, or $240,000. Since the actual labor costs were $210,000, the workers will get a gainsharing bonus based on the $30,000 difference between the $240,000 target and the actual cost.

Scanlon Plan
A gainsharing program in which employees receive a bonus if the ratio of labor costs to the sales value of production is below a set standard.

Typically, an organization does not pay workers all of the gain immediately. First, the organization keeps a share of the gain to improve its own bottom line. A portion of the remainder goes into a reserve account. This account offsets losses in any months when the gain is negative (that is, when costs rise or production falls). At the end of the year, the organization closes out the account and distributes any remaining surplus. If there were a loss at the end of the year, the organization would absorb it.

Figure 12.3

Finding the Gain in a Scanlon Plan

$$\text{Target Ratio: } \frac{\text{Labor Costs}}{\text{Sales Value of Production}} = \frac{20}{100}$$

Sales Value of Production: $1,200,000

$$\text{Goal: } \frac{20}{100} \times \$1{,}200{,}000 = \$240{,}000$$

Actual: $210,000

Gain: $240,000 – $210,000 = $30,000

SOURCE: Example adapted from B. Graham-Moore and Timothy L. Ross, *Gainsharing: Plans for Improving Performance* (Washington, DC: Bureau of National Affairs, 1990), p. 57.

Group Bonuses and Team Awards

In contrast to gainsharing plans, which typically reward the performance of all employees at a facility, bonuses for group performance tend to be for smaller work groups.[20] These

HR Oops!

Programs That Discourage Safety

The Occupational Health and Safety Administration has expressed concern that when companies set up programs to reward safety, they sometimes end up *discouraging* safe behavior. The problem occurs when companies offer incentives for low reports of injuries and illnesses—for example, giving a bonus if all the workers during a shift at a facility "work safely" with no accidents during a year. Under that type of program, if a worker does get hurt, the worker might feel bad about reporting the injury, or co-workers might discourage the worker from reporting the injury, because the injury report would cause them to lose the bonus.

Failure to report injuries can lead to future problems. For example, the failure to report could make it harder to identify and correct safety hazards. Also, a minor injury such as a repetitive-stress injury might keep getting worse until the employee can no longer bear to keep it a secret. In that case, the individual employee and company would have been better off if the employee had reported the injury sooner.

One alternative that has been suggested is for companies to reward employees for engaging in practices that increase safety rather than reward them for the absence of injury and illness reports.

Questions

1. What performance measures could a company use to identify and reward safe behavior in addition to counting injuries and illnesses?
2. Are the measures you identified in question 1 suitable for group bonuses, individual bonuses, or both? What are the advantages of rewarding safety at the group level? At the individual level?

Source: Based on Jennifer Stroschein, "OSHA Is Watching," *Industrial Safety & Hygiene News*, October 2009, Business & Company Resource Center, http://galenet.galegroup.com.

Group members that meet a sales goal or a product development team that meets a deadline or successfully launches a product may be rewarded with a bonus for group performance. What are some advantages and disadvantages of group bonuses?

bonuses reward the members of a group for attaining a specific goal, usually measured in terms of physical output. Team awards are similar to group bonuses, but they are more likely to use a broad range of performance measures, such as cost savings, successful completion of a project, or even meeting deadlines.

Both types of incentives have the advantage that they encourage group or team members to cooperate so that they can achieve their goal. However, depending on the reward system, competition among individuals may be replaced by competition among groups. Competition may be healthy in some situations, as when groups try to outdo one another in satisfying customers. On the downside, competition may also prevent necessary cooperation among groups. To avoid this, the organization should carefully set the performance goals for these incentives so that concern for costs or sales does not obscure other objectives, such as quality, customer service, and ethical behavior (see "HR Oops!").

LO4 Explain how organizations link pay to their overall performance.

Pay for Organizational Performance

Two important ways organizations measure their performance are in terms of their profits and their stock price. In a competitive marketplace, profits result when an organization is efficiently providing products that customers want at a price they are willing to pay. Stock is the owners' investment in a corporation; when the stock price is rising, the value of that investment is growing. Rather than trying to figure out what performance measures will motivate employees to do the things that generate high profits and a rising stock price, many organizations offer incentive pay tied to those organizational performance measures. The expectation is that employees will focus on what is best for the organization.

These organization-level incentives can motivate employees to align their activities with the organization's goals. At the same time, linking incentives to the organization's profits or stock price exposes employees to a high degree of risk. Profits and stock price can soar very high very fast, but they can also fall. The result is a great deal of uncertainty about the amount of incentive pay each employee will receive in each period. Therefore, these kinds of incentive pay are likely to be most effective in organizations that emphasize growth and innovation, which tend to need employees who thrive in a risk-taking environment.[21]

Profit Sharing

Profit Sharing
Incentive pay in which payments are a percentage of the organization's profits and do not become part of the employees' base salary.

Under **profit sharing,** payments are a percentage of the organization's profits and do not become part of the employees' base salary. For example, General Motors provides for profit sharing in its contract with its workers' union, the United Auto Workers. Depending on how large GM's profits are in relation to its total sales for the year, at least 6 percent of the company's profits are divided among the workers according to how many hours they worked during the year.[22] The formula for computing and dividing the profit-sharing bonus is included in the union contract.

Organizations use profit sharing for a number of reasons. It may encourage employees to think more like owners, taking a broad view of what they need to do in order to make the organization more effective. They are more likely to cooperate and less likely to focus on narrow self-interests. Also, profit sharing has the practical advantage of costing less when the organization is experiencing financial difficulties. If the organization has little or no profit, this incentive pay is small or nonexistent, so employers may not need to rely as much on layoffs to reduce costs.[23]

Does profit sharing help organizations perform better? The evidence is not yet clear. Although research supports a link between profit-sharing payments and profits, researchers have questioned which of these causes the other.[24] For example, Ford, Chrysler, and GM have similar profit-sharing plans in their contracts with the United Auto Workers, but the payouts are not always similar. In one year, the average worker received $4,000 from Ford, $550 from GM, and $8,000 from Chrysler. Since the plans are similar, something other than the profit sharing must have made Ford and Chrysler more profitable than GM.

Differences in payouts, as in the preceding example, raise questions not only about the effectiveness of the plans, but about equity. Assuming workers at Ford, Chrysler, and GM have similar jobs, they would expect to receive similar profit-sharing checks. In the year of this example, GM workers might have seen their incentive pay as highly inequitable unless GM could show how Chrysler workers did more to earn their big checks. Employees also may feel that small profit-sharing checks are unfair because they have little control over profits. If profit sharing is offered to all employees but most employees think only management decisions about products, price, and marketing have much impact on profits, they will conclude that there is little connection between their actions and their rewards. In that case, profit-sharing plans will have little impact on employee behavior. This problem is even greater when employees have to wait months before profits are distributed. The time lag between high-performance behavior and financial rewards is simply too long to be motivating.

focus on **social responsibility**

An organization setting up a profit-sharing plan should consider what to do if profits fall. If the economy slows and profit-sharing payments disappear along with profits, employees may become discouraged or angry. Andersen Corporation, maker of doors and windows, recently faced this problem. The company has included profit sharing in its compensation since 1914. In 2007, Andersen had been able to pay its employees profit sharing equal to 22.5 percent of their salaries. A year later, the company paid out just 6.5 percent of salaries in profit sharing, and in 2009, for the first time since the Great Depression, there were no profit-sharing checks at all.[25] Management communicated with employees frankly about the company's appreciation of their efforts and the difficulty of the economic environment, in which construction has been hit especially hard. The hope is that employees' recognition of the role the economy plays in cyclical industries such as construction will enable them to see the compensation as fair, even if they are disappointed in the year's results.

Given the limitations of profit-sharing plans, one strategy is to use them as a component of a pay system that includes other kinds of pay more directly linked to individual behavior. This increases employees' commitment to organizational goals while addressing concerns about fairness.

Stock Ownership

While profit-sharing plans are intended to encourage employees to "think like owners," a stock ownership plan actually makes employees part owners of the organization. Like profit sharing, employee ownership is intended as a way to encourage employees to focus on the success of the organization as a whole. The drawbacks of stock ownership as a form of incentive pay are similar to those of profit sharing. Specifically, it may not have a strong effect on individuals' motivation. Employees may not see a strong link between their actions and the company's stock price, especially in larger organizations. The link between pay and performance is even harder to appreciate because the financial benefits mostly come when the stock is sold—typically when the employee leaves the organization.

Ownership programs usually take the form of *stock options* or *employee stock ownership plans*. These are illustrated in Figure 12.4.

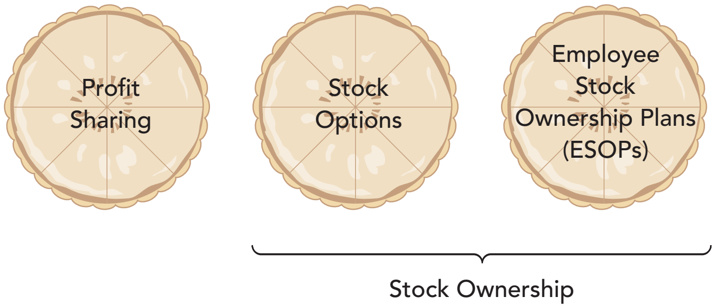
Stock Options

Stock Options
Rights to buy a certain number of shares of stock at a specified price.

One way to distribute stock to employees is to grant them **stock options**—the right to buy a certain number of shares of stock at a specified price. (Purchasing the stock is called *exercising* the option.) Suppose that in 2005 a company's employees received options to purchase the company's stock at $10 per share. The employees will benefit

Figure 12.4

Types of Pay for Organizational Performance



if the stock price rises above $10 per share, because they can pay $10 for something (a share of stock) that is worth more than $10. If in 2010 the stock is worth $30, they can exercise their options and buy stock for $10 a share. If they want to, they can sell their stock for the market price of $30, receiving a gain of $20 for each share of stock. Of course, stock prices can also fall. If the 2010 stock price is only $8, the employees would not bother to exercise the options.

Traditionally, organizations have granted stock options to their executives. During the 1990s, many organizations pushed eligibility for options further down in the organization's structure. Walmart and PepsiCo are among the large companies that have granted stock options to employees at all levels. Stock values were rising so fast during the 1990s that options were extremely rewarding for a time.

Some studies suggest that organizations perform better when a large percentage of top and middle managers are eligible for long-term incentives such as stock options. This evidence is consistent with the idea of encouraging employees to think like owners.[26] It is not clear whether these findings would hold up for lower-level employees. They may see much less opportunity to influence the company's performance in the stock market.

Recent scandals have drawn attention to another challenge of using stock options as incentive pay. As with other performance measures, employees may focus so much on stock price that they lose sight of other goals, including ethical behavior. Ideally, managers would bring about an increase in stock price by adding value in terms of efficiency, innovation, and customer satisfaction. But there are other, unethical ways to increase stock price by tricking investors into thinking the organization is more valuable and more profitable than it actually is. Hiding losses and inflating the recorded value of revenues are just two of the ways some companies have boosted stock prices, enriching managers until these misdeeds come to light. Also, officials at some companies, including K B Homes and United Healthcare, have been charged with "backdating" options granted to executives. This practice involves changing the date and/or price in the original option agreement so that the option holder can buy stock at a bargain price—making the backdated option profitable or more profitable. At the same time, backdating eliminates or reduces the incentive to improve the stock's performance. If backdating of options is kept secret, those who do it may be guilty of falsifying financial statements, which is unethical and may be illegal.[27]

Employee Stock Ownership Plans

While stock options are most often used with top management, a broader arrangement is the **employee stock ownership plan (ESOP).** In an ESOP, the organization distributes shares of stock to its employees by placing the stock into a trust managed on the employees' behalf. Employees receive regular reports on the value of their stock, and when they leave the organization, they may sell the stock to the organization or (if it is a publicly traded company) on the open market.

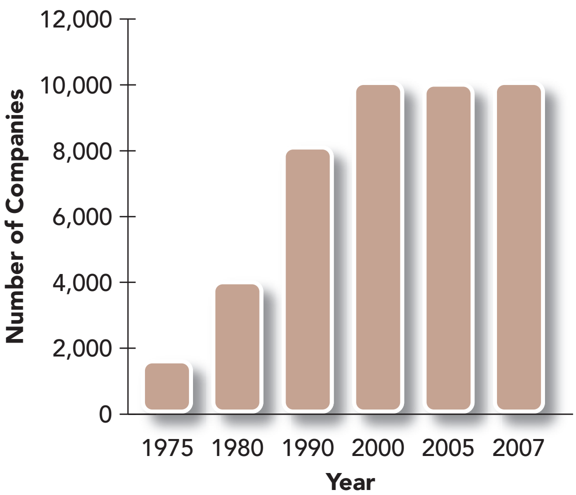
Employee Stock Ownership Plan (ESOP)
An arrangement in which the organization distributes shares of stock to all its employees by placing it in a trust.

ESOPs are the most common form of employee ownership, with the number of employees in such plans increasing from over 3 million in 1980 to more than 12 million in the past few years in the United States.[28] Figure 12.5 shows the growth in the number of ESOPs in the United States. One reason for ESOPs' popularity is that earnings of the trust holdings are exempt from income taxes.

ESOPs raise a number of issues. On the negative side, they carry a significant risk for employees. By law, an ESOP must invest at least 51 percent of its assets in the company's own stock (in contrast to other kinds of stock funds that hold a wide diversity of companies). Problems with the company's performance therefore can

Figure 12.5

Number of Companies with ESOPs



SOURCE: National Center for Employee Ownership, "A Statistical Profile of Employee Ownership," NCEO Web site, updated March 2010, www.nceo.org.

take away significant value from the ESOP. Many companies set up ESOPs to hold retirement funds, so these risks directly affect employees' retirement income. Adding to the risk, funds in an ESOP are not guaranteed by the Pension Benefit Guarantee Corporation (described in Chapter 13). Sometimes employees use an ESOP to buy their company when it is experiencing financial problems; this is a highly risky investment.

Still, ESOPs can be attractive to employers. Along with tax and financing advantages, ESOPs give employers a way to build pride in and commitment to the organization. Employees have a right to participate in votes by shareholders (if the stock is registered on a national exchange, such as the New York Stock Exchange).[29] This means employees participate somewhat in corporate-level decision making. Still, the overall level of participation in decisions appears to vary significantly among organizations with ESOPs. Some research suggests that the benefits of ESOPs are greatest when employee participation is greatest.[30]

Balanced Scorecard

LO5 Describe how organizations combine incentive plans in a "balanced scorecard."

As the preceding descriptions indicate, any form of incentive pay has advantages and disadvantages. For example, relying exclusively on merit pay or other individual incentives may produce a workforce that cares greatly about meeting those objectives but competes to achieve them at the expense of cooperating to achieve organizational goals. Relying heavily on profit sharing or stock ownership may increase cooperation but do little to motivate day-to-day effort or to attract and retain top individual performers. Because of this, many organizations design a mix of pay programs. The aim is to balance the disadvantages of one type of incentive pay with the advantages of another type.

Balanced Scorecard
A combination of performance measures directed toward the company's long- and short-term goals and used as the basis for awarding incentive pay.

One way of accomplishing this goal is to design a **balanced scorecard**—a combination of performance measures directed toward the company's long- and short-term goals and used as the basis for awarding incentive pay. A corporation would have financial goals to satisfy its stockholders (owners), quality- and price-related goals to satisfy its customers, efficiency goals to ensure better operations, and goals related to acquiring skills and knowledge for the future to fully tap into employees' potential. Different jobs would contribute to those goals in different ways. For example, an engineer could develop products that better meet customer needs and can be produced more efficiently. The engineer could also develop knowledge of new technologies in order to contribute more to the organization in the future. A salesperson's goals would include measures related to sales volume, customer service, and learning about product markets and customer needs. Organizations customize their balanced scorecards according to their markets, products, and objectives. The scorecards of a company that is emphasizing low costs and prices would be different from the scorecards of a company emphasizing innovative use of new technology.

Tellabs is one company that uses a balanced scorecard. The company conducts quarterly meetings at which employees learn how their performance will be evaluated according to the scorecard. The company also makes this information available on the intranet.

Table 12.2 shows the kinds of information that go into a balanced scorecard. This sample scorecard is similar to one used for Blue Ridge Electric Membership Corporation, a cooperative that delivers electricity to its member-owners in North Carolina. The company gathers input from all levels of employees to create goals for member (customer) service, financial performance, safety, and innovation and learning. These are communicated to all employees, and all employees receive incentive pay based on whether the company meets its base, target, or stretch goals in each area. For example, employees earn 2 percent of their salary as incentive pay if the organization meets all of its base goals, including power interruptions lasting no longer than 140 minutes on average and operating expenses held to 4.03 cents per kilowatt-hour generated. If the company reaches the target or stretch goals, then the incentive pay will be 3 percent or 5 percent, respectively. If the company meets some of the goals but not others, the incentive pay is calculated as a portion of the total incentive. For example, each of the member service goals is worth 20 percent of the total incentive pay, so meeting both of these goals contributes 40 percent of an employee's incentive pay. Since Blue Ridge started using the balanced scorecard in the 1990s, it has increased its member satisfaction score, reduced its cost of service, improved reliability, and earned the best safety record among North Carolina's power distribution companies.[31]

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Not only does the balanced scorecard combine the advantages of different incentive-pay plans, it helps employees understand the organization's goals. By communicating the balanced scorecard to employees, the organization shows employees information about what its goals are and what it expects employees to accomplish. In Table 12.2, for example, the organization indicates not only that the manager should meet the four performance objectives but also that it is especially concerned with the financial target, because half the incentive is based on this one target.

Table 12.2

Sample Balanced Scorecard for an Electric Cooperative

PERFORMANCE CATEGORY	CRITICAL SUCCESS FACTORS	GOALS		
		BASE (2%)	TARGET (3%)	STRETCH (5%)
Member service (40% of incentive pay)	Reliability (average interruption duration)	140 min.	130 min.	120 min.
	Customer satisfaction (index from quarterly survey)	9.0	9.1	9.2
Financial performance (25% of incentive pay)	Total operating expenses (¢/kilowatt-hour)	4.03¢	3.99¢	3.95¢
	Cash flow (% of investment)	75%	80%	85%
Internal processes (20% of incentive pay)	Safety (safety index based on injury rate and severity)	4.6	3.6	2.6
Innovation and learning (15% of incentive pay)	Member value (revenue/kWh sold)	Budget	−10% state median	−13% state median
	Efficiency and effectiveness (total margins/no. employees)	$534,400	$37,200	$40,000

SOURCE: Adapted from Tim Sullivan and Henry Cano, "Introducing a Balanced Scorecard for Electric Cooperatives: A Tool for Measuring and Improving Results," *Management Quarterly,* Winter 2009, Business & Company Resource Center, http://galenet.galegroup.com.

LO6 Summarize processes that can contribute to the success of incentive programs.

Processes That Make Incentives Work

As we explained in Chapter 11, communication and employee participation can contribute to a belief that the organization's pay structure is fair. In the same way, the process by which the organization creates and administers incentive pay can help it use incentives to achieve the goal of motivating employees. The monetary rewards of gainsharing, for example, can substantially improve productivity,[32] but the organization can set up the process to be even more effective. In a study of an automotive parts plant, productivity rose when the gainsharing plan added employee participation in the form of monthly meetings with managers to discuss the gainsharing plan and ways to increase productivity. A related study asked employees what motivated them to participate actively in the plan (for example, by making suggestions for improvement). According to employees, other factors besides the pay itself were important—especially the ability to influence and control the way their work was done.[33]

Participation in Decisions

Employee participation in pay-related decisions can be part of a general move toward employee empowerment. If employees are involved in decisions about incentive pay plans and employees' eligibility for incentives, the process of creating and administering these plans can be more complex.[34] There is also a risk that employees will make decisions that are in their interests at the expense of the organization's interests.

However, employees have hands-on knowledge about the kinds of behavior that can help the organization perform well, and they can see whether individuals are displaying that behavior.[35] Therefore, in spite of the potential risks, employee participation can contribute to the success of an incentive plan. This is especially true when monetary incentives encourage the monitoring of performance and when the organization fosters a spirit of trust and cooperation.

Communication

Along with empowerment, communicating with employees is important. It demonstrates to employees that the pay plan is fair. Also, when employees understand the requirements of the incentive pay plan, the plan is more likely to influence their behavior as desired.

It is particularly important to communicate with employees when changing the plan. Employees tend to feel concerned about changes. Pay is a frequent topic of rumors and assumptions based on incomplete information, partly because of pay's importance to employees. When making any changes, the human resource department should determine the best ways to communicate the reasons for the change. Some organizations rely heavily on videotaped messages from the chief executive officer. Other means of communication include brochures that show examples of how employees will be affected. The human resource department may also conduct small-group interviews to learn about employees' concerns, then address those concerns in the communications effort. The "eHRm" box describes how companies use Web sites to help, provide employees with more ways to effectively understand and manage their pay.

Incentive Pay for Executives

LO7 Discuss issues related to performance-based pay for executives.

Because executives have a much stronger influence over the organization's performance than other employees do, incentive pay for executives warrants special attention. Assuming that incentives influence performance, decisions about incentives for executives should have a great impact on how well the executives and the organization perform. Along with overall pay levels for executives (discussed in Chapter 11), organizations need to create incentive plans for this small but important group of employees.

To encourage executives to develop a commitment to the organization's long-term success, executive compensation often combines short-term and long-term incentives. *Short-term incentives* include bonuses based on the year's profits, return on investment, or other measures related to the organization's goals. Sometimes, to gain tax advantages, the actual payment of the bonus is deferred (for example, by making it part of a retirement plan). *Long-term incentives* include stock options and stock purchase plans. The rationale for these long-term incentives is that executives will want to do what is best for the organization because that will cause the value of their stock to grow.

Each year *BusinessWeek* publishes a list of top executives who did the most for their pay (that is, their organizations performed best) and those who did the least. The performance of the latter group has prompted much of the negative attention that executive pay has received. The problem seems to be that in some organizations, the chief executive's pay is high every year, regardless of the organization's profitability or performance in the stock market. In terms of people's judgments about equity, it seems fairer if high-paid executives must show results to justify their pay levels.

A corporation's shareholders—its owners—want the corporation to encourage managers to act in the owners' best interests. They want managers to care about the

eHRM

FINANCIAL EDUCATION ONLINE

Employees get the most value from—and appreciation of—their benefits if they understand how to manage their financial assets. As employers are coming to appreciate this fact, they are also recognizing that online training is an efficient and convenient way to deliver a financial education.

For example, the insurance company Axa set up a financial-education program for employees on a Web page titled "My Budget Day." Each employee is given one hour a month of paid work time to visit "My Budget Day" and use its interactive tools to calculate the costs and benefits of various spending and saving decisions. They can learn about creating a family budget and a retirement plan. The setup gives employees flexibility and convenience, and they report feeling "more in control of their finances."

Along with recorded training presentations on DVDs and podcasts, online training offers the power of the computer for showing employees how to get the most out of their earnings. Online modeling tools can show employees how the value of their stock can grow over time if they don't sell it immediately. Or employees can see how the power of compound interest can make their bonus or profit-sharing check grow if they invest it in various ways.

Sources: "Financial Education: Axa Ensures Engagement with Online Facility," *Employee Benefits,* April 1, 2010, Business & Company Resource Center, http://galenet.galegroup.com; "Best Practice: Face Up to Provision of Multi-Site Financial Education," *Employee Benefits,* February 8, 2008; and "Financial Education: Cache of Literacy," *Employee Benefits,* October 8, 2007, both downloaded from General Reference Center Gold, http://find.galegroup.com.

company's profits and stock price, and incentive pay can encourage this interest. One way to achieve these goals is to tie a large share of executives' pay to performance. In a *BusinessWeek* survey, almost 80 percent of chief executives' pay came in the form of stock options and other incentive pay based on long-term performance objectives. Another study has found that relying on such long-term incentives is associated with greater profitability.[36]

Warren Buffett must be doing something right. The billionaire once was ranked by *BusinessWeek* magazine as being the top executive who gave shareholders the most for their pay.

Performance Measures for Executives

The balanced-scorecard approach is useful in designing executive pay. Whirlpool, for example, has used a balanced scorecard that combines measures of whether the organization is delivering value to shareholders, customers, and employees. These measures are listed in Table 12.3. Rewarding achievement of a variety of goals in a balanced scorecard reduces the temptation to win bonuses by manipulating financial data.

Regulators and shareholders have pressured companies to do a better job of linking executive pay and performance. The Securities and Exchange Commission (SEC) has required companies to more clearly report executive compensation levels and the company's performance relative to that of competitors. These reporting requirements shine a light on situations where executives of poorly performing companies receive high pay, so companies feel more pressure to link pay to performance. Some forms of incentive pay also have tax advantages. Under the

Table 12.3

Balanced Scorecard for Whirlpool Executives

TYPE OF VALUE CREATION	MEASURES
Shareholder value	Economic value added
	Earnings per share
	Cash flow
	Total cost productivity
Customer value	Quality
	Market share
	Customer satisfaction
Employee value	High-performance culture index
	High-performance culture deployment
	Training and development diversity

SOURCE: E. L. Gubman, *The Talent Solution* (New York: McGraw-Hill, 1998).

Omnibus Budget Reconciliation Act of 1993, companies may not deduct executive pay that exceeds $1 million, but performance-related pay (including stock options) is exempt, so it is deductible even over $1 million.

Ethical Issues

Incentive pay for executives lays the groundwork for significant ethical issues. When an organization links pay to its stock performance, executives need the ethical backbone to be honest about their company's performance even when dishonesty or clever shading of the truth offers the tempting potential for large earnings. As recent scandals involving WorldCom, Enron, Global Crossing, and other companies have shown, the results can be disastrous when unethical behavior comes to light.

Among these issues is one we have already touched on in this chapter: the difficulty of setting performance measures that encourage precisely the behavior desired. In the case of incentives tied to stock performance, executives may be tempted to inflate the stock price in order to enjoy bonuses and valuable stock options. The intent is for the executive to boost stock value through efficient operations, technological innovation, effective leadership, and so on. Unfortunately, individuals at some companies determined that they could obtain faster results through accounting practices that stretched the norms in order to present the company's performance in the best light. When such practices are discovered to be misleading, stock prices plunge and the company's reputation is damaged, sometimes beyond repair.

A related issue when executive pay includes stock or stock options is insider trading. When executives are stockholders, they have a dual role as owners and managers. This places them at an advantage over others who want to invest in the company. An individual, a pension fund, or other investors have less information about the company than its managers do—for example, whether product development is proceeding on schedule, whether a financing deal is in the works, and so on. An executive who knows about these activities could therefore reap a windfall in the stock market by buying or selling stock based on knowledge about the company's future. The SEC places strict limits on this "insider trading," but some executives have violated these limits. In the worst cases executives have sold stock, secretly knowing their company was failing, before the stock price collapsed. The losers are the employees, retirees, and other investors who hold the now-worthless stock.

As recent news stories have reminded us, linking pay to stock price can reward unethical behavior, at least in the short term and at least in the minds of a handful of executives. Yet, given the motivational power of incentive pay, organizations cannot afford to abandon incentives for their executives. These temptations are among the reasons that executive positions demand individuals who maintain the highest ethical standards.

thinking ethically

SHOULD EMPLOYEES GIVE BACK BONUSES AFTER BAILOUTS?

Disastrous trades made by the financial-products division of American International Group (AIG) nearly caused the insurance giant to go out of business in 2008, until the U.S. government moved in with money to keep the company afloat. With public funds invested in this private business, citizens were infuriated when they learned that AIG would pay its financial-products employees retention bonuses totaling $168 million in 2009 and again when the company announced $195 million would be paid in retention bonuses in 2010.

Under pressure from the Obama administration's "pay czar" Kenneth Feinberg, AIG asked employees in the financial-products group if they would be willing to take a cut in the amount of their 2010 bonuses in exchange for being paid ahead of schedule. In addition, the company asked the employees to give back some of the bonuses they had received a year earlier. Most of the employees—over 95 percent—agreed, and some of them offered to take a bigger cut than the 10 percent requested or to pay back some of the bonus money not repaid by others (including individuals who had left the company).

This situation unfolded as other financial companies were enduring criticism about their incentive pay. Banks such as Citigroup and Bank of America justified paying bonuses to their investment-banking employees on the grounds that these employees normally receive a sizable share of their pay in the form of bonuses, so eliminating or even scaling back bonuses would present a severe hardship to employees who were working hard to unravel the tangle of toxic assets.

Questions

1. If a company performs poorly, is it ethical for its employees to receive a performance bonus? Who wins and who loses if they do?
2. When, if ever, is it ethical for a company to ask its employees to give back part of a bonus they have already been paid?
3. What are the ethical risks, if any, of making incentive pay a large share of employees' total compensation? How should a company balance or reduce these risks?

SOURCES: Serena Ng and Joann S. Lublin, "AIG Gets Strong Response on Bonus Cuts," *Wall Street Journal,* January 29, 2010, http://online.wsj.com; David Enrich, Sara Schaefer Muñoz, and Aaron Lucchetti, "Banks See Way Past Limits," *Wall Street Journal,* January 28, 2010, http://online.wsj.com; and Susanne Craig, David Enrich, and Robin Sidel, "Banks Brace for Bonus Fury," *Wall Street Journal,* January 11, 2010, http://online.wsj.com.

SUMMARY

LO1 Discuss the connection between incentive pay and employee performance.

Incentive pay is pay tied to individual performance, profits, or other measures of success. Organizations select forms of incentive pay to energize, direct, or control employees' behavior. It is influential because the amount paid is linked to predefined behaviors or outcomes. To be effective, incentive pay should encourage the kinds of behavior that are most needed, and employees must believe they have the ability to meet the performance standards. Employees must value the rewards, have the resources they need to meet the standards, and believe the pay plan is fair.

LO2 Describe how organizations recognize individual performance.

Organizations may recognize individual performance through such incentives as piecework rates, standard hour plans, merit pay, sales commissions, and bonuses for meeting individual performance objectives. Piecework rates pay employees according to the amount they produce. Standard hour plans pay workers extra for work done in less than a preset "standard time." Merit pay links increases in wages or salaries to ratings on performance appraisals. Bonuses are similar to merit pay, because they are paid for meeting individual goals, but they are not rolled into base pay, and they usually are based on achieving a specific output, rather than subjective performance ratings. A sales commission is incentive pay calculated as a percentage of sales closed by a salesperson.

LO3 Identify ways to recognize group performance.

Common group incentives include gainsharing, bonuses, and team awards. Gainsharing programs, such as Scanlon plans, measure increases in productivity and distribute a portion of each gain to employees. Group bonuses reward the members of a group for attaining a specific goal, usually measured in terms of physical output. Team awards are more likely to use a broad range of performance measures, such as cost savings, successful completion of a project, or meeting a deadline.

LO4 Explain how organizations link pay to their overall performance.

Incentives for meeting organizational objectives include profit sharing and stock ownership. Profit-sharing plans pay workers a percentage of the organization's profits; these payments do not become part of the employees' base salary. Stock ownership incentives may take the form of stock options or employee stock ownership plans. A stock option is the right to buy a certain number of shares at a specified price. The employee benefits by exercising the option at a price lower than the market price, so the employee benefits when the company's stock price rises. An employee stock ownership plan (ESOP) is an arrangement in which the organization distributes shares of its stock to employees by placing the stock in a trust managed on the employees' behalf. When employees leave the organization, they may sell their shares of the stock.

LO5 Describe how organizations combine incentive plans in a "balanced scorecard."

A balanced scorecard is a combination of performance measures directed toward the company's long- and short-term goals and used as the basis for awarding incentive pay. Typically, it includes financial goals to satisfy stockholders, quality- and price-related goals for customer satisfaction, efficiency goals for improved operations, and goals related to acquiring skills and knowledge for the future. The mix of pay programs is intended to balance the disadvantages of one type of incentive with the advantages of another type. The balanced scorecard also helps employees to understand and care about the organization's goals.

LO6 Summarize processes that can contribute to the success of incentive programs.

Communication and participation in decisions can contribute to employees' feeling that the organization's incentive pay plans are fair. Employee participation in pay-related decisions can be part of a general move toward employee empowerment. Employees may put their own interests first in developing the plan, but they also have firsthand insight into the kinds of behavior that can contribute to organizational goals. Communicating with employees is important because it demonstrates that the pay plan is fair and helps them understand what is expected of them. Communication is especially important when the organization is changing its pay plan.

LO7 Discuss issues related to performance-based pay for executives.

Because executives have such a strong influence over the organization's performance, incentive pay for them receives special attention. Executive pay usually combines long-term and short-term incentives. By motivating executives, these incentives can significantly affect the organization's performance. The size of incentives should be motivating but also meet standards for equity. Performance measures should encourage behavior that is in the organization's best interests, including ethical behavior. Executives need ethical standards that keep them from insider trading or deceptive practices designed to manipulate the organization's stock price.

KEY TERMS

balanced scorecard, p. 370
commissions, p. 363
differential piece rates, p. 359
employee stock ownership plan (ESOP), p. 369
gainsharing, p. 364
incentive pay, p. 356
merit pay, p. 360
piecework rate, p. 358
profit sharing, p. 367
Scanlon plan, p. 365
standard hour plan, p. 360
stock options, p. 368
straight piecework plan, p. 358

REVIEW AND DISCUSSION QUESTIONS

1. With some organizations and jobs, pay is primarily wages or salaries, and with others, incentive pay is more important. For each of the following jobs, state whether you think the pay should emphasize base pay (wages and salaries) or incentive pay (bonuses, profit sharing, and so on). Give a reason for each.
   a. An accountant at a manufacturing company.
   b. A salesperson for a software company.
   c. A chief executive officer.
   d. A physician in a health clinic.
2. Consider your current job or a job that you have recently held. Would you be most motivated in response to incentives based on your individual performance, your group's performance, or the organization's overall performance (profits or stock price)? Why?
3. What are the pros and cons of linking incentive pay to individual performance? How can organizations address the negatives?
4. Suppose you are a human resource professional at a company that is setting up work teams for production and sales. What group incentives would you recommend to support this new work arrangement?
5. Why do some organizations link incentive pay to the organization's overall performance? Is it appropriate to use stock performance as an incentive for employees at all levels? Why or why not?
6. Stock options have been called the pay program that "built Silicon Valley," because of their key role as incentive pay for employees in high-tech companies. They were popular during the 1990s, when the stock market was rising rapidly. Since then, stock prices have fallen.
   a. How would you expect this change to affect employees' attitudes toward stock options as incentive pay?
   b. How would you expect this change to affect the effectiveness of stock options as an incentive?
7. Based on the balanced scorecard in Table 12.2, find the incentive pay for an employee earning a salary of $4,000 a month in each of the following situations.
   a. The company met all of its target goals for the year. (Multiply the percentage at the top of the table by the employee's salary.)
   b. The company met only its target goals for financial performance (25 percent of the total incentive pay) but none of the other goals.
   c. The company met its stretch goals for financial performance and its base goals in the other areas. (For each category of goals, multiply the percentages by the employee's salary, and then add the amounts together.)
8. Why might a balanced scorecard like the one in Question 7 be more effective than simply using merit pay for a manager?
9. How can the way an organization creates and carries out its incentive plan improve the effectiveness of that plan?
10. In a typical large corporation, the majority of the chief executive's pay is tied to the company's stock price. What are some benefits of this pay strategy? Some risks? How can organizations address the risks?

BUSINESSWEEK CASE

BusinessWeek BMW Aligns Executive Bonuses with Workers' Bonuses

BMW became the first major blue-chip German company to link the bonuses of its top managers to those of its assembly line workers, amid growing global criticism of executive compensation. The move sends a strong message to other firms also examining their compensation practices, as the world's largest banks in particular have come under fire from politicians, shareholders and the public over excessive bonuses during one of the worst economic crises the world has seen.

BMW plans to tie executive bonuses to those of its blue-collar workers, in a bid to create a fairer and sustainable compensation environment within the company. Starting in 2010, the company will use a common formula to ascertain and award bonuses to its upper- and lower-level employees, based on the company's performance as measured by profit, sales and other factors. That means that upper-level management could potentially lose more money than their lower-level counterparts for bad performance, BMW said.

A spokesman for BMW said the company's goal was to create fair and transparent compensation practices and to prevent a gap between management and the workers, as the under class, from developing. "We don't just want to build sustainable cars. We also want to have sustainable personnel politics. We think this is good for the company culture," the spokesman told *Spiegel Online*. He declined to be more specific on how the formula will work.

Other companies may follow BMW's example as pressure grows on firms to curb excessive bonuses in the wake of the financial crisis. German Chancellor Angela Merkel has been outspoken about her dislike for excessive bonuses, calling them "inappropriate."

U.S. President Barack Obama has also been outspoken about excessive compensation. In June 2009, he appointed attorney Kenneth Feinberg to oversee compensation practices at seven companies that received bailout funds from the government. To that end, Feinberg has devised a plan to cut the total compensation for these companies in half.

Joseph Sorrentino, managing director with Steven Hall & Partners, a U.S.-based executive compensation consulting firm, said a combination of factors including political pressure, government bailouts, public pressure and the declining stock market has led to many companies re-examining their compensation practices to make sure they are effectively paying for performance and not encouraging excessive risk-taking.

"Companies are trying to make sure they balance the public outcry with what they need to make sure they are able to attract and retain their employees," Sorrentino told *Spiegel Online*. He added that often when big companies such as BMW change their compensation practices, other companies take notice.

To be sure, the BMW spokesman said the company has been discussing its compensation practices for months, and that its announcement has nothing to do with the larger debate over executive compensation circulating through governments currently.

However, Harald Krüger, BMW's human resources director, was critical of the bonus structure of banks and other businesses. "If employees need the money or bonuses for motivation, it encourages harmful developments inside a company," the executive told *Frankfurter Allgemeine Sonntagszeitung* newspaper.

SOURCE: Excerpted from Christopher Lawton, "BMW Links Exec Pay to Line Workers," *BusinessWeek*, October 27, 2009, www.businessweek.com.

Questions

1. Based on the information given, summarize the method(s) BMW intends to use for determining incentive pay. Are these rewards for individual, group, and/or company performance?
2. Explain BMW's claim that under the new bonus program, "upper-level management could potentially lose more money than their lower-level counterparts for bad performance." Does this sound like a system that would support BMW's business strategy? Why or why not?
3. BMW says that one motivation for the new bonus method is to establish "sustainable personnel politics" in which employees have a positive relationship with the company. Describe how you think employees would rate the fairness of tying executive bonuses to their bonuses. Describe how you think executives would rate the plan's fairness. Why is fairness an important quality of incentive pay?

Case: Incentive Pay Part of the Strategy at Nucor

Nucor is not your average steel company. Compared with its traditionally managed competitors, Nucor is aggressive about pushing decision making down to the lowest levels of the hierarchy, and it links two-thirds of pay to performance, specifically production levels. That strategy has opened the company up to employee-driven changes that have made the company efficient, flexible, and innovative. Its use of new technology in the form of electric arc furnaces lets the company shut down and start up operations faster to meet demand for its process of melting down scrap metal and shaping it to meet customers' needs.

Nucor's practices may be different, but the company resembles its competitors in one way: when building construction crashed to a halt and manufacturing orders dried up, Nucor joined other steel companies in facing a shocking drop-off in demand. As orders fell, so did output: in the last quarter of 2008, production went from 95 percent of capacity to 50 percent, and it continued to fall to 45 percent in 2009.

At that point, Nucor's reliance on incentive pay went from an advantage in motivating workers to a serious problem of how to keep morale up. As bonuses shrank, total compensation fell by up to 40 percent. The company looked at its overall performance in 2008, which included a modest profit despite the end-of-the-year downturn, and paid all its employees profit sharing totaling $270 million. In addition, the company awarded a special one-time bonus of up to $2,000. More recently, it began offering financial counseling and the option to withdraw funds from employees' profit-sharing accounts.

Of course, the pain is felt at the top as well. Incentive pay is the norm for executives at most companies, and here Nucor is no exception. Chief Executive Officer Dan DiMicco saw a 23 percent drop in his total compensation in 2008, for example. Much of the drop was caused by a 46 percent decline in the value of stock awarded to DiMicco.

One advantage of tying part of employees' pay to profits is that Nucor can afford to keep more workers on board during lean times. The company has avoided layoffs and assigned otherwise-idle workers to review safety programs, find ways to cut costs, carry out preventive maintenance, and even mow the lawns. If Nucor can't motivate workers with money, it can at least show them the company is trying to save their jobs.

Employees seem to appreciate the effort. CEO DiMicco told a reporter, "[Our employees] go further than we would ever think to ask. It makes you feel really good about being a leader in this company when you have that kind of support."

That positive attitude has helped management lead the company to prepare for growth even as employees endured hard times. It's a commitment that is likely to reap dividends as demand picks up and profits begin to roll in again. With production rising above 70 percent of capacity and expected to hit 90 percent in some mills, the future is again looking bright for Nucor and its employees.

SOURCES: Nanette Byrnes, "Pain, but No Layoffs at Nucor," *BusinessWeek*, March 26, 2009, www.businessweek.com; Adam Bell, "Nucor CEO DiMicco Sees Total Pay Drop 23 Percent in 2008," *Charlotte (N.C.) Observer*, March 26, 2009, Business & Company Resource Center, http://galenet.galegroup.com; Stella M. Hopkins, "Special Bonus, Profit-Sharing Options Aid Nucor Workers," *Charlotte (N.C.) Observer*, August 16, 2009, Business & Company Resource Center, http://galenet.galegroup.com; and Edmond Lococo, "Nucor Posts Second Straight Profit as Shipments Rise," *BusinessWeek*, April 26, 2010, www.businessweek.com.

Questions

1. Nucor gives its employees a relatively great say in decision making along with compensation tied to performance. Discuss how incentive pay could be more effective when it is linked to greater authority and room to innovate.
2. When times are tough, incentive pay falls even if employees are trying hard. In that case, should companies find other ways to reward employees? Why or why not? Evaluate Nucor's use of a "special bonus" in this situation.
3. Cutting compensation by paying smaller production bonuses and no profit sharing when orders dried up might have helped Nucor avoid layoffs. Evaluate the fairness of this approach. Does the fact that the chief executive also earned less make the situation fairer? Would you rather work for a company that lays off employees in lean times or one that offers no incentive pay in lean times? Why?

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- Chapter quiz

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