Chapter 12
Pay for Performance and Financial Incentives

Strategic Overview
- Pay must be linked to performance
- If not, employees look for raises in good times or bad
- Chapter 11 focused on developing pay plans
- Here we discuss incentive plans and compensation packages

Money and Motivation
- Incentives motivate workers
- See “systematic soldiering” without them
- Taylor standardized a fair day’s work
- Which led to the scientific management movement
- Which in turn led to modern day HR practices
Performance and Pay

- Competition, shareholder value, and turbulence
- Businesses need an edge
  - Question: What do you think that edge is?
- Pay attention

Types of Incentive Plans

- Individual
- Group
- Profit sharing
- Employee group
- Variable pay

Incentives for Operations Employees

- Piecework
- Straight piecework
- Standard hour plan
- All must guarantee minimum wage
- Can create quality problems
Incentives for Operations Employees

- Team or group incentive plans
  - All members receive the pay earned by the highest producer
  - Members receive pay equal to the average pay earned by the group
  - All members receive the pay earned by the lowest producer

Incentives for Managers and Executives

<table>
<thead>
<tr>
<th>Incentives breakdown for a mature company</th>
<th>Incentives breakdown for a startup company</th>
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<tbody>
<tr>
<td>Salary</td>
<td>Short term</td>
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<tr>
<td>20%</td>
<td>20%</td>
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<tr>
<td>10%</td>
<td>10%</td>
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The Annual Bonus

A bonus is aimed at motivating short term performance with three issues to consider when awarding them:
- Eligibility – based on job level and salary
- Fund size – use a formula
- Individual awards – based on performance
Manager’s Performance Bonus

- Bonus for managers is either individual or corporate performance based or both
- Split it with part based on individual performance rest on corporate performance
- Never give outstanding performers too little
- Never give poor performers normal or average awards

Multiplier approach for bonus

Long Term Incentives

- Stock options
- Different stock option plans
- Performance plans
- Cash plans
- Other plans

Long Term Incentives (Cont.)

- Other Plans
  - Stock appreciation
  - Performance achievement
  - Stock options
  - Phantom stock
- Performance Plans
- Cash Versus Stock Options
Stock Options

- A stock option is the right to purchase a stated number of shares of a company stock at a preset price at some time in the future
- A mega-option grant is a large, upfront stock option grant in lieu of annual grants
- Some stock plans are different for each employee
- A restricted stock option is an option grant which has constraints on its use

Performance Plans

- Executives do not prosper unless the company does
- Executives have some “skin in the game”
- Value is contingent on financial performance

Cash Versus Stock Options

Which do you think is a better motivator?
Long-Term Incentives For Overseas Executives

- Tax implications can be tricky
- May be responsible for both US and foreign taxes – may defeat the incentive
- Plans must consider various factors:
  - Tax treatment
  - Regulatory environment
  - Foreign exchange controls

Strategy and Executive Compensation

- Long-term incentives have a profound impact on strategic success
- When designing a compensation plan, 1st define strategic context
- Create package
- Ignore firm’s strategy at your own peril

Steps to a Compensation Package

- Include external and internal issues
  - What are our long term goals?
  - How can compensation support them?
- What defines the work culture and how can the package be molded to it?
  - What are our competitive challenges?
  - What are our specific business objectives?
Steps to a Compensation Package (Cont.)

- Shape components into balanced plan
- Meet unique company and strategic needs
- Legal and tax effective
- Install a review and evaluation process

Incentives for Salespeople - Salaries

- Sales compensation can be salaried, commission-based or hybrid
- Salaries make sense when job is primarily prospecting or servicing clients
- Useful when relocating to new territories
- Can de-motivate very productive workers

Incentives for Salespeople - Commissions

- Pay only for results
- Easy to understand and compute
- Focus only on high volume items
- May ignore non-selling aspects
- Performance is a product of ability
- May result in high turnover
Research Insight – Commissions Only

“If I go on vacation, I lose money. If I’m sick, I lose money. If I’m not willing to drop everything on a moment’s notice to close with a customer, I lose money. I can’t see how anyone could stay in this job for long. It’s like a trapeze act and I’m working without a net!”

Incentives for Salespeople - Combination

- These are the 3 most common salary/commission ratios
- All cushion downside risk while also limiting upside reward
- Next slide shows a more complicated formula

Incentives for Salespeople - Combination

- Sales:
  - Up to $18,000 a month = base salary + 7% of gross profits + 0.5% of gross sales
  - From $18,000 to $25,000 a month = base salary + 9% of gross profits
  - Over $25,000 a month = base salary + 10% of gross profits
  - All three steps include an additional amount of 0.5% of gross sales
Online Award Programs

- The $30 billion Corporate incentives programs market is growing
- Programs can be costly to administer so many companies are looking online

Setting Sales Quotas

- Setting effective quotas is an art
- Make sure commissions match expenses
- Ask these questions:
  - Have we communicated quotas to the sales force within one month of the start of the period?
  - Does the sales force know exactly how its quotas are set?
  - Do you combine bottom-up information with top-down requirements?
  - Does 60% to 70% of the sales force generally hit their quota?
  - Are quotas stable through the performance period?

Auto Dealer Commissions

Insight into why auto salespersons behave the way they do:
- Some are 100% commission based
- Others get commissions and small base salary
- Net profit of car
- Slow movers may get “spiff”
Professional and Non-managerial Incentives

- Merit pay or a merit raise is any salary increase awarded an employee based on individual performance
- Usually granted exempt employees

Merit Pay Options

- Lump sum raises are not cumulative; traditional raise is
- Lump sum can be a bigger motivator

Incentives for Professionals

- Determining this type of incentive is challenging
- Professionals are well-paid and driven
- Keep highly motivated professionals by using:
  - Stock options and profit sharing
  - Better vacations
  - Home offices
  - Improved pension plans
Variable pay plans include:
- Profit sharing
- Employee Stock Ownership Program (ESOP)
- Scanlon or gain-sharing plans
- At risk plans

Employees share in some part of profits
- In cash plans
- Lincoln incentive plan
- Deferred plans

Builds a sense of commitment and ownership in company
- Positive tax advantages for company and employee
- ERISA allows firm to borrow against stock held in trust
ESOP – Research Insight

- Thermacore transformed itself
- Attributes success to its employees and rewards them with annual bonus and ESOP program
- All employees get identical bonus
- ESOP is purchased by allotment of private stock

Scanlon Plan

- An incentive plan developed in 1937 by Joseph Scanlon and designed to encourage cooperation, involvement, and sharing of benefits

Gainsharing

- A modern Scanlon type plan where cost savings are shared
- Eight basic steps:
Making Gainsharing Work

- Use multiple measures
  - Productivity cost performance, product damage, customer complaints, shipping errors, safety, and attendance
- Committed managers
- Straightforward formula
- Employee involvement

At Risk Plans

- Some portion of weekly pay at risk
- Exceed goals and get extra pay
- Miss goals and lose some pay
- Employees become committed partners
- Relies on trust, respect, communication and opportunities for advancement

Ameristeel’s Incentive Plan

- Having a tough time, Ameristeel made all employees partners in the business
- All employees took immediate cut in pay
  - All other pay became part of pay at risk plan
  - Pay was tied to steel production
- Plan worked with profits up 40%
Why Incentive Plans Can Fail

- Performance pay can’t replace good management
- You get what you pay for
- Pay is not a motivator
- Rewards punish
- Rewards rupture relationships

Why Incentive Plans Can Fail

- Rewards can unduly restrict performance
- Rewards may undermine responsiveness
- Rewards undermine intrinsic motivation
- People work for more than money

Implementing Incentive Plans

- Use common sense
- Incentive linked to strategy
- Effort linked to reward
- Easily understood
- Set effective standards
- Standard is a contract
- Get support
- Use accurate measurement
- Long and short view
- Consider corporate culture
- Comprehensive commitment oriented approach
In small company, life cycles are short and broad-based, profit sharing is preferred to individual incentives or gainsharing. Incentive payments should be included in overtime and computation can be complex.

Alison worked 45 hours @ $6.00/hr + $18 bonus

Total $288.00

Which is correct?

Total $304.00

FedEx’s pay plan illustrates how firms use innovative incentive plans to boost quality and productivity. Uses quarterly pay reviews and has a strong emphasis on pay for performance.

- Profit sharing
- Golden falcon award