Chapter 10

Pay-for-Performance Plans
Learning Objectives

After studying Chapter 10, students should be able to:

1. Discuss reasons for adopting variable pay-for-performance plans.
2. Explain the types of individual pay-for-performance plans.
3. Explain the types of team/group incentive plans.
4. Discuss and explain why an employer might choose a group rather than an individual incentive system.
5. Explain the differences between short term and long term pay-for-performance plans.
6. Discuss the difficulties of adopting variable pay-for-performance plans and how they can be overcome.
Pay for performance plans signal a movement away from entitlements.

Pay will vary with some measure of individual, team, or organizational performance.
Purposes of Pay-for-Performance

- Attain strategic goals
- Reinforce organizational norms
- Motivate performance at the individual, group, and organizational levels
- Recognize differential employee contributions
## Use of Different Variable Pay Plan Types

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>1996</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
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<td>Special Recognition Plans</td>
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<td>15</td>
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Performance Pay Obstacles

- Difficulties in specifying and measuring job performance
- Problems in identifying valued rewards
- Difficulties in linking rewards to job performance
Short Term Pay-for-Performance Plans

- Merit Pay
- Lump-Sum Bonuses
- Individual Spot Awards
- Individual Incentives
Difficulties in Rewarding Performance with Merit Base Pay Increases

- Economics
- Lack of flexibility
- Permanence
- Individual focus
Under a system of individual incentives, all or a portion of an individual’s pay is tied to their performance.
## Individual Incentive Plans

<table>
<thead>
<tr>
<th>Method of Rate Determination</th>
<th>Units of production per time period</th>
<th>Time period per unit of production</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pay constant function of production level</td>
<td>(1) Straight piecework plan</td>
<td>(2) Standard hour plan</td>
</tr>
<tr>
<td>Relationship between production level and pay</td>
<td>Bedeaux plan</td>
<td></td>
</tr>
<tr>
<td>Pay varies as function of production level</td>
<td>(3) Taylor differential piece rate system</td>
<td>(4) Halsey 50 - 50 method</td>
</tr>
<tr>
<td></td>
<td>Merrick multiple piece rate system</td>
<td>Rowan plan</td>
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<tr>
<td></td>
<td></td>
<td>Gantt plan</td>
</tr>
</tbody>
</table>
Advantages of Individualized Incentive Plans

- Substantial contribution to:
  - raise productivity
  - lower production costs
  - increase earnings of workers

- Less direct supervision is required to maintain reasonable levels of output than under payment by time.

- Systems of payment by results (if accompanied by improved organizational and work measurement) enable labor costs to be estimated more accurately than under payment by time.
  - This helps costing and budgetary control.
Disadvantages of Individualized Incentive Plans

- Greater conflict may emerge between employees seeking to maximize output and managers concerned about deteriorating quality levels.
- Attempts to introduce new technology may be resisted by employees concerned about the impact on production standards.
- Reduced willingness of employees to suggest new production methods for fear of subsequent increases in production standards.
Disadvantages of Individualized Incentive Plans
(continued)

- Increased complaints that equipment is poorly maintained, hindering employee efforts to earn larger incentives.
- Increased turnover among new employees discouraged by the unwillingness of experienced workers to cooperate in on-the-job training.
- Elevated levels of mistrust between workers and management.
Team / Group Incentive Plans

- Gain-Sharing Plans
- Profit Sharing Plans
- Earnings-at-Risk Plans
Group Incentives

- Improve Organizational Performance
- Organizational Measures
- Measured Periodically
Sample Group/Team Performance Measures

**Customer-Focused Measures**

- **Time to Market Measures**
  - On time delivery
  - Cycle time
  - New product introductions

- **Customer Satisfaction Measures**
  - Market share
  - Customer satisfaction
  - Customer growth and retention
  - Account penetration

**Financially-Focused Measures**

- **Value Creation**
  - Revenue growth
  - Resource yields
  - Profit margins
  - Economic value added

- **Shareholder Return**
  - Return on invested capital
  - Return on sales / earnings
  - Earnings per share
  - Growth in profitability
## Capability-Focused Measures

- **Human Resources Capabilities**
  - Employee satisfaction
  - Turnover rates
  - Total recruitment costs
  - Rate of progress on developmental plans
  - Promotability index
  - Staffing mix/head-count ratio

- **Other Asset Capabilities**
  - Patents and copyrights
  - Distribution systems

## Internal Process-Focused Measures

- **Resource Utilization**
  - Budget-to-actual expenses
  - Cost allocation ratios
  - Reliability / rework
  - Accuracy / error rates
  - Safety rates

- **Change Effectiveness**
  - Program implementation
  - Teamwork effectiveness
  - Service / quality index
Different Types of Variable Pay Plans

- Cash Profit Sharing
- Stock Ownership or Options
- Balanced Scorecard
- Productivity / Gain-Sharing
- Team / Group Incentives
Gain-Sharing Plans

Under gain-sharing plans, employees earn bonuses tied to unit-wide performance as measured by a predetermined, gainsharing formula.
Key Elements in Designing a Gain-Sharing Plan

- Strength of reinforcement
- Productivity standards
- Sharing the gains
- Scope of the formula
- Perceived fairness of the formula
- Production variability
Primary Types of Gain-Sharing Plans

**Scanlon Plan**

- Designed to lower labor costs without lowering the level of a firm’s activity.
- Incentives are derived as a function of the ratio between labor costs and sales value of production (SVOP).
- SVOP includes sales revenue and the value of goods in inventory.

**Rucker Plan**

- A ratio is calculated that expresses the value of production required for each dollar of total wage bill.
Primary Types of Gain-Sharing Plans
(continued)

Implementation of Scanlon / Rucker Plans

- There are two major components vital to implementation and success:
  1. A productivity norm
  2. Development of effective worker committees

Improshare

- A standard is developed which identifies the expected hours required to produce an acceptable level of output.
- Any savings arising from production of the agreed-upon output in fewer than the expected hours is shared by the firm and by the worker.
### Three Gain-Sharing Formulas

<table>
<thead>
<tr>
<th></th>
<th>Scanlon Plan (single ratio volume)</th>
<th>Rucker Plan</th>
<th>Improshare</th>
</tr>
</thead>
<tbody>
<tr>
<td>Numerator of ratio</td>
<td>Payroll costs</td>
<td>Labor cost</td>
<td>Actual hours worked</td>
</tr>
<tr>
<td>(input factor)</td>
<td></td>
<td></td>
<td>worked</td>
</tr>
<tr>
<td>Denominator of ratio</td>
<td>Net sales (plus or minus inventories)</td>
<td>Value added</td>
<td>Total standard value hours</td>
</tr>
<tr>
<td>(outcome factor)</td>
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Small group incentive systems are similar to gainsharing plans; but in this case, the bonus employees receive is based on the performance of a small group instead of an entire department, division, or plant.
Profit-Sharing Plans

- Employees receive an annual bonus or shares in the company based upon company-wide performance.
- Employees are either paid in cash, or their earnings are deferred into a retirement plan.
Advantages of Group Incentive Plans

- Positive impact on organization and individual performance of about 5 – 10 percent per year.
- Easier to develop performance measures than for individual plans.
- Signals that cooperation, both within and across groups, is a desired behavior.
- Teamwork meets with enthusiastic support from most employees.
- May increase participation of employees in decision making process.
Disadvantages of Group Incentive Plans

- Line of sight may be lessened.
  - Employees may find it more difficult to see how their individual performance affects their incentive payouts.

- May lead to increased turnover among top individual performers who are discouraged because they must share with lesser contributors.

- Increases compensation risk to employees because of lower income stability.
Example of Group Incentives: GE Information Systems

- A team-based incentive with links to individual payouts.
- Team and individual performance goals are set.
- If the team hits its goals, the team members earn their incentive only if they hit their individual goals.
- The team incentive is 12% to 15% of monthly base pay.
Example of Group Incentives: Corning Glass

A gain-sharing program (goal sharing) where 75% of the payout is based on unit objectives such as:
- quality measures
- customer satisfaction measures
- production targets

The remainder is based on Corning’s return on equity (ROE)
Example of Group Incentives: 3-M

- Operates with an earnings-at-risk plan
- Base pay is fixed at 80% of market
- Employees have a set of objectives to meet for pay to move to 100% of market
- Additionally, there is a modest profit sharing component
Example of Group Incentives: Saturn

- Earnings-at-risk plan where base pay is 93% of market
- Employees meet individual objectives to capture at-risk component
- All team members must meet objectives for any to get at-risk money
- A profit sharing component is based on corporate profits
Example of Group Incentives: Du Pont Fibers

- Earnings-at-risk where employees receive reduced pay increases over five years, resulting in 6 percent lower base pay.
- If the department meets annual profit goal, employees collect all 6 percent.
- Variable payout ranges from 0 (less than 80 percent of goal) to 12 percent (150 percent of goal).
Long-Term Incentive Plans

- Employee Stock Ownership Plans (ESOPs)
- Performance Plans (Performance Share and Performance Unit)
- Broad-Based Option Plans (BBOP)
Long-Term Incentives and Their Risk/Reward Tradeoffs

**Level One: Low Risk/Reward**
- Time-based restricted stock
- Performance – accelerated restricted stock
- Stock purchase plan

**Level Two: Medium Risk/Reward**
- Time-vested stock option
- Performance – vested restricted stock
- Performance – accelerated stock option
Long-Term Incentives and Their Risk/Reward Tradeoffs

Level Three: High Risk/Reward

- Premium-priced stock option
- Indexed stock option
- Performance – vested stock option
Conditions for Effective Variable Pay-for-Performance Plans

- Plan is clearly communicated
- Plan is understood
- Rewards are easy to calculate
- Employees participate in administering the plan
- Employees believe they are being treated fairly
- Employees believe they can trust the company and that they have security
- Rewards are awarded as soon as possible after the desired performance.
The Serious Implications of Variable Pay-for-Performance (1 of 2)

◆ When a substantial portion of pay is tied to performance, that portion becomes variable - can go up or down - based upon individual, group, or company performance.

◆ This change is significant.

◆ The nature of authority relationships and status in the organization might change.
The Serious Implications of Variable Pay-for-Performance (2 of 2)

- Employees will demand, and the operation of the systems themselves might require, increased sharing of information.

- Finally, variable pay-for-performance systems will create heightened pressure for performance and cost containment within the organization. This pressure will come not just from managers, but from employees themselves.
The design and effective administration of pay-for-performance plans is key to their success.

Having a good idea is not enough.

The good idea must be followed up by sound practices that recognize rewards can, if used properly, shape employee behavior.
Review Questions

1. You have been asked by your boss to evaluate whether a gain-sharing plan would work in your organization. What conditions would you like to see exist before you would be comfortable making a positive recommendation?

2. Your firm is experiencing turnover problems with top-level employees (directors, vice presidents at all levels). As the VP of HR, you have been asked by the company president to fix the problem. While your primary emphasis might be on having a competitive base pay, is there anything you can do with incentives? Justify your answer.
3. How is an earnings-at-risk plan different from an ordinary gain-sharing or profit-sharing plan? How might earnings-at-risk plans affect attraction and retention of employees?

4. If you wanted to create a work environment where employees offered more new product suggestions, and suggested new industries where these suggestions might be applied, what type of compensation plan would you recommend? What are some of the problems you need to be aware of?