

9

Direct Financial Compensation (Core Compensation)

CHAPTER OBJECTIVES After completing this chapter, you should be able to:

- 1. Describe direct financial compensation (core compensation), indirect financial compensation (employee benefits), and nonfinancial compensation.
- 2. Identify and discuss the components of direct financial compensation.
- 3. Review the determinants of direct financial compensation.
- 4. Describe contextual influences on direct financial compensation.
- 5. Discuss how to use job evaluation to build job structures.
- 6. Describe various competitive compensation policies.
- 7. Explain the use of compensation surveys for job pricing and determining market competitive pay structures.
- 8. Discuss compensation for sales representatives.
- 9. Discuss compensation for contingent workers.
- 10. Explain executive compensation and the various features of executive compensation packages.

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A Society of Human Resource Management (SHRM) survey of human resources (HR) executives identified “retaining and rewarding the best employees as their number one challenge.”¹ We’ve discussed several practices in this book, thus far, that HR professionals rely on to facilitate the attainment of this goal. Compensation also is an important tool toward meeting this objective. For instance, highly successful companies, such as software developer and manufacturer Adobe, provide highly competitive compensation packages that consist of lucrative pay amounts and employee benefits (for example, health insurance). In fact, Adobe is among the top 25 companies that offers extremely generous compensation amounts.²

OBJECTIVE 9.1

Describe direct financial compensation (core compensation), indirect financial compensation (employee benefits), and nonfinancial compensation.

Compensation

Total of all rewards provided employees in return for their services.

Direct financial compensation (core compensation)

Pay that a person receives in the form of wages, salary, commissions, and bonuses.

Indirect financial compensation (employee benefits)

All financial rewards that are not included in direct financial compensation

Nonfinancial compensation

Satisfaction that a person receives from the job itself or from the psychological and/or physical environment in which the person works.

Compensation: An Overview

Compensation is the total of all rewards provided employees in return for their work. The components of a total compensation program are shown in Figure 9-1.

The overall purpose of compensation is to attract, retain, and motivate employees. There are at least three mechanisms by which compensation contributes to this purpose. First, pay helps define a person’s standard of living. All else equal, higher pay enables people to meet their most basic needs such as food and shelter more easily than those who earn less. Also, higher pay enables people to enjoy the finer things in life such as frequenting gourmet restaurants, driving a luxury car, and taking exotic vacations. Second, pay level influences an employee’s attitudes such as job satisfaction, which, in turn, should contribute to better job performance. Third, the type of payment such as incentive pay aligns the interests of employees with a company’s mission. Employees and companies alike strive to maximize their earnings. Incentive compensation serves this common interest. For instance, sales employees have the potential to earn greater amounts of incentive pay for the attainment of progressively higher sales goals. From the company’s perspective, higher sales contribute to increased earnings.

Direct financial compensation (core compensation) consists of the pay that a person receives in the form of wages, salaries, commissions, and bonuses. **Indirect financial compensation (employee benefits)** consists of all financial rewards that are not included in direct financial compensation. This form of compensation includes a wide variety of rewards normally received indirectly by the employee such as paid vacation and medical care. **Nonfinancial compensation** consists of the satisfaction that a person receives from the job itself or from the psychological or physical environment in which the person works. Although our focus will not be on nonfinancial compensation, it is worth giving brief consideration through an illustration to better describe the total compensation concept.



FIGURE 9-1
Components of a Total Compensation Program

Compensation			
Financial		Nonfinancial	
<u>Direct</u>	<u>Indirect (Benefits)</u>	<u>The Job</u>	<u>Job Environment</u>
Wages Salary Commissions Bonuses	Legally Required Benefits Social Security Unemployment Compensation Workers' Compensation Family & Medical Leave Discretionary Benefits Paid Time Off Health Care Life Insurance Retirement Plans Employee Stock Option Plans Employee Services Premium Pay	Meaningful Appreciated Satisfying Learning Enjoyable Challenging	Sound Policies Capable Managers Competent Employees Congenial Coworkers Appropriate Status Symbols Working Conditions Workplace Flexibility Flextime Compressed Workweek Job Sharing Telecommuting Part-Time Work

Employers may choose to award nonfinancial compensation to complement an employee's paycheck, especially when economic conditions make it difficult to provide higher pay. Examples of nonfinancial compensation practices include training for employees who value professional development and flexible work scheduling for those who give high priority to work-life balance. As you will learn in the following Watch It video, the effectiveness of nonfinancial compensation practices significantly depends on knowing each employee as an individual to provide options of interest and value to them.

Watch It I

If your professor has assigned this, sign into mymanagementlab.com to watch a video titled Motivation (TWZ Role Play) and to respond to questions.

Managers tend to view financial compensation as both an expense and an asset. It is an expense in the sense that it reflects the cost of labor. For example, on average, companies spent \$31.57 per hour worked per employee in December 2013. Of this total, companies spent \$21.77 on wages and \$9.80 on all employee benefits.³ The costs of labor continually rise. For example, the cost of wages rose, on average, 1.9 percent between December 2012 and December 2013. The increase in the cost of benefits was greater, equaling 2.2 percent.⁴

Financial compensation is instrumental in recruiting and hiring good people and in encouraging them to put forth their best efforts and remain in their jobs. A firm that pays well attracts many applicants, enabling management to pick and choose the skills and traits it values. It holds on to these quality hires by equitably sharing the fruits of its financial success, not only among the management team but also with the rank and file. Compensation programs have top management's attention because they have the potential to influence employee work attitudes and behavior that lead to improved organizational performance and achieving the firm's strategic plan. We can find evidence for top management's interest in many of the "About Careers" sections of company Web sites. For example, the U.S. Office of Personnel Management (OPM) describes the role and importance of careers in its various U.S. federal government agencies, including the OPM:

OPM helps the President manage the civil service of the Federal government. While our work has a direct impact on employees and Departments/agencies throughout the Federal government, don't forget that we are an employer of choice in our own right. We are looking for candidates like you to help OPM implement crucial initiatives like the Affordable Care Act and develop policies, products and services for the Federal workforce! We offer employees the rewarding experience of guiding and advising on myriad human resource challenges as well as contributing to an effective and efficient merit system of employment in Government.⁵

OBJECTIVE 9.2

Identify and discuss the components of direct financial compensation.

Base pay

The monetary compensation employees earn on a regular basis for performing their jobs. Hourly pay and salary are the main forms of base pay.

hourly pay

One type of base pay. Employees earn hourly pay for each hour worked.

salary

One type of base pay. Employees earn salaries for performing their jobs, regardless of the actual number of hours worked. Companies generally measure salary on an annual basis.

cost-of-living adjustment (COLA)

Escalator clause in a labor agreement that automatically increases wages as the U.S. Bureau of Labor Statistics' cost-of-living index rises.

real hourly compensation

Measure of the purchasing power of a dollar.

nominal hourly compensation

The face value of a dollar.

seniority

Length of time an employee has been associated with the company, division, department, or job.

seniority pay

Pay program in which pay increases are based on length of service.

human capital theory

A theory premised on the idea that employees' knowledge and skills generate productive capital known as human capital. Employees can develop knowledge and skills from formal education or on-the-job experiences.

Components of Direct Financial Compensation

There are five types of direct financial compensation. These include employee base pay, cost-of-living adjustments, seniority pay, pay-for-performance, and person-focused pay. An employee's direct financial compensation rarely consists of all five components. Most employees receive base pay, and companies choose which of the remaining four types of financial compensation to include. Companies choose one additional or combination of direct financial compensation components for employee groups based on how best to direct employee job performance (for example, sales employees versus clerical employees). Also, factors such as labor unions influence how direct employee compensation is structured.

Employee Base Pay

Most employees receive base pay, which we describe momentarily. Over time, HR professionals work with managers and supervisors to make adjustments to base pay. There are a variety of methods for making these adjustments. HR professionals work with managers and supervisors to adjust employee base pay based on one or more of the remaining four types of direct financial compensation.

Base Pay

Employees receive **base pay**, or money, for performing their jobs. Base pay is recurring; that is, employees continue to receive base pay as long as they remain in their jobs. Companies disburse base pay to employees in one of two forms: **hourly pay** or **wage** or as **salary**. Employees earn hourly pay for each hour worked. They earn salaries for performing their jobs, regardless of the actual number of hours worked. Companies measure salary on an annual basis. The Fair Labor Standards Act established criteria for determining whether employees should be paid hourly or by salary. In July 2013, the average weekly rate for workers was approximately \$824.⁶ On an annual basis, this figure translates to \$42,848 (based on a 40-hour work week over 52 calendar weeks).

Cost-of-Living Adjustments

Cost-of-living adjustments (COLAs) represent periodic base pay increases that are founded on changes in prices as recorded by the consumer price index (CPI). In recent years, the typical COLA equaled approximately 2–3 percent annually. COLAs enable workers to maintain their purchasing power and standard of living by adjusting base pay for inflation. **Real hourly compensation** measures the purchasing power of a dollar, whereas **nominal hourly compensation** is the face value of a dollar. Increases in the costs of goods and services cause nominal pay to be less than real pay. For example, let's assume that an employee accepted a job at \$10 per hour. This figure—\$10 per hour—represents nominal pay. At the same time, \$10 also represents real pay. However, over 1 year, let's assume that the price of goods and services increased, on average, 5 percent. At the end of the year, nominal hourly pay remains at \$10. Hourly real pay, on the other hand, declined by 5 percent, or \$0.50. In other words, \$10 purchases only \$9.50 worth of goods and services. In this example, \$9.50 represents hourly real pay.

COLAs are most common among workers represented by unions because one of the main goals of unionization is to protect the standard of living of its membership. When a union emphasizes cost of living, it may try to pressure management into including a COLA, which rarely is found outside unionized employment settings. Provisions for COLAs are contained in an escalator clause in the labor agreement that automatically increases wages as the U.S. Bureau of Labor Statistics' cost-of-living index (*Consumer Price Index*) rises. The average hourly union wage remains substantially higher than nonunion wages (\$24.18 versus \$20.10).⁷ Some of the differential can be attributed to the use of COLA in union settings.

Seniority Pay

Seniority is the length of time an employee has been associated with the company, division, department, or job. **Seniority pay** systems reward employees with periodic additions to base pay according to employees' length of service in performing their jobs. These pay plans assume that employees become more valuable to companies with time and that valued employees will leave if they do not have a clear idea that their salaries will progress over time.⁸ This rationale comes from **human capital theory**,⁹ which, as we discussed in earlier chapters, states that employees'

Craig E. Schneier, the HR boss at biotechnology giant Biogen Idec, does not believe that all employees and positions are equal. At Biogen, one vice-president might get double what another vice-president in the next office will get.¹⁷ Certainly this philosophy bodes well for many Generation Y employees because they want to be rewarded based on their individual performance and do not believe the time a person devotes to the job should be a primary consideration.¹⁸

It has become increasingly difficult to justify merit pay increases based on a previous employment period but added perpetually to base pay. There are many long-term employees who are poor performers who have high salaries because of past automatic cost-of-living increases. Although numerous companies continue with traditional merit pay plans, some companies are starting to quietly freeze or cut pay for some so as to be able to reward others. According to Myrna Hellerman, senior vice-president at Sibson Consulting, "much can be learned from best-practices companies where base pay increases must be earned, based on demonstrated individual achievement. Pay raises are not an entitlement; the entitlement era is over."¹⁹

MERIT BONUSSES Companies are increasingly placing a higher percentage of their compensation budget in **merit bonuses**, which is a one-time annual financial award, based on productivity that is not added to base pay. This approach better enables companies to control the cost of direct compensation by not adding pay increases to base pay on a permanent basis, which is the case for seniority and merit pay. Figure 9-3 shows the differences in cost between the use of merit pay and merit bonuses.

More and more companies embrace the concept of *pay for performance*. Recently when the economy was slowing down and employers were holding down across-the-board pay raises, companies still put a large percentage of salary budgets toward bonuses.²⁰ A recent survey found that 70 percent of employers offer bonuses as a reward to employees.²¹ The use of bonuses helps managers control their cash outlay in a tough business environment while laying the foundation to share success with top producers.²² Managers commonly contend that the use of bonuses is a win-win situation because it boosts production and efficiency and gives employees some control over their earning power. A positive side effect of using bonuses to reward high performance is that it may encourage coworkers to increase their productivity so that they can also receive the bonuses.

merit bonus

One-time annual financial award, based on productivity that is not added to base pay.

FIGURE 9-3
Permanent Annual Merit
Increases versus Bonus
Awards: A Comparison

(At the end of 2014, John Smith earned an annual salary of \$35,000.)					
Year	Increase Amount (%)	Cost of Increase (Total Current Salary—2014 Annual Salary)		Total Salary under	
		Permanent Merit Increase (\$)	Bonus Award (\$)	Permanent Merit Increase (Percent Increase × Previous Annual Salary) (\$)	Bonus Award Annual (Percent Increase × 2014 Salary) (\$)
2015	3	1,050	1,050	36,050	36,050
2016	5	2,853	1,750	37,853	36,750
2017	4	4,367	1,400	39,367	36,400
2018	7	7,122	2,450	42,122	37,450
2019	6	9,649	2,100	44,649	37,100
2020	5	11,881	1,750	46,881	36,750
2021	3	13,287	1,050	48,287	36,050
2022	6	16,185	2,100	51,185	37,100
2023	8	20,279	2,800	55,279	37,800
2024	7	24,148	2,450	59,148	37,450

spot bonus

Relatively small monetary gifts provided to employees for outstanding work or effort during a reasonably short period of time.

incentive pay

Compensation, other than base wages or salaries, that fluctuates according to employees' attainment of some standard (e.g., a pre-established formula, individual or group goals, or company earnings).

Many organizations today are providing *spot bonuses* for critical areas and talents. **Spot bonuses** are relatively small monetary gifts provided to employees for outstanding work or effort during a reasonably short period of time. If an employee's performance has been exceptional, the employer may reward the worker with a one-time bonus of as low as \$50 and \$100 or \$500. For certain professional jobs, it is not unheard of for a highly productive worker to receive \$5,000 shortly after a noteworthy achievement.

INCENTIVE PAY **Incentive pay** rewards employees for partially or completely attaining a predetermined work objective. Incentive or variable pay is defined as compensation—other than base wages or salaries—that fluctuates according to employees' attainment of some standard, such as a pre-established formula, individual or group goals, or company earnings.²³ Much like seniority and merit pay approaches, incentive pay augments employees' base pay, but incentive pay appears as one-time payments. Employees usually receive a combination of recurring base pay and incentive pay, with base pay representing the greater portion of direct financial compensation. More employees are presently eligible for incentive pay than ever before, as companies seek to control costs and motivate personnel continually to strive for exemplary performance. Companies increasingly recognize the importance of applying incentive pay programs to various kinds of employees as well, including production workers, technical employees, and service workers.

Companies generally institute incentive pay programs to control payroll costs or to motivate employee productivity. Companies can control costs by replacing annual merit or seniority increases or fixed salaries with incentive plans that award pay raises only when the company enjoys an offsetting rise in productivity, profits, or some other measure of business success. Well-developed incentive programs base pay on performance, so employees control their own compensation levels. Companies can choose incentives to further business objectives.

There are many kinds of incentive pay plan options. Companies use incentive pay to reward individual employees, groups of employees, or whole companies based on their performance. Management typically relies on business objectives to determine incentive pay levels.

INDIVIDUAL INCENTIVE PLANS In this section, we will review the four commonly used individual incentive pay plans: piecework, management incentives, behavioral encouragement plans, and referral plans. Then, we will briefly address the pros and cons of individual incentive plans.

Piecework is an incentive pay plan in which employees are paid for each unit they produce. For example, if a worker is paid \$8 a unit and produces 10 units a day, the worker earns \$80. Sometimes a guaranteed base is included in a piece-rate plan, meaning that a worker would receive this base amount no matter what the output. Historically, piecework is especially prevalent in the production/operations area. Requirements for the plan include developing output standards for the job and being able to measure the output of a single employee. Piecework pay plans have declined in use somewhat because the plan requires constant monitoring. For instance, if on day one the worker produced 8 units and on day two the worker produced 12 units, each day must be counted separately. Also, professionals such as industrial engineers are needed to maintain the system. Obviously, a piecework plan would not be feasible for many jobs.

Management incentive plans award bonuses to managers when they meet or exceed objectives based on sales, profit, production, or other measures for their division, department, or unit. Management incentive plans differ from piecework plans in that piecework plans base rewards on the attainment of one specific objective, and management incentive plans often require multiple complex objectives. For example, management incentive plans reward managers for increasing market share or reducing their budgets without compromising the quality and quantity of output. The best-known management incentive plan is management by objectives (MBO).²⁴ When used as part of incentive programs, superiors communicate the amount of incentive pay managers will receive based on the attainment of specific goals. As an aside, when MBO is used as part of merit pay systems, superiors make subjective assessments of managers' performance, and they use these assessments to determine permanent merit pay increases.

Under **behavioral encouragement plans**, employees receive payments for specific behavioral accomplishments (e.g., good attendance or safety records). For example, companies usually

piecework

Incentive pay plan in which employees are paid for each unit they produce.

management incentive plans

Bonuses to managers who meet or exceed objectives based on sales, profit, production, or other measures for their division, department, or unit.

behavioral encouragement plans

Individual incentive pay plans that reward employees for specific such behavioral accomplishments as good attendance.

award monetary bonuses to employees who have exemplary attendance records for a specified period. When behavioral encouragement plans are applied to safety records, workers earn awards for lower personal injury or accident rates associated with the improper use of heavy equipment or hazardous chemicals. Behavioral encouragement plans have the potential to save companies substantially more money than the cost of these awards. For example, frequent absenteeism in a company's workforce could disrupt production goals and quality. Customers may respond by choosing to make purchases for better quality products from other companies. Loss of customer bases will have a negative impact on profitability and reputation that prompts prospective customers to choose alternate sources to purchase products.

Referral plans

Individual incentive pay plans for rewarding the referral of new customers or recruiting successful job applicants.

Companies commonly rely on **referral plans** to enhance recruitment of highly qualified employees. Employees may receive monetary bonuses for referring new customers or recruiting successful job applicants. In the case of recruitment, employees can earn bonuses for making successful referrals for job openings. For example, there has been a tremendous shortage of nurses for the past several years. Because of the shortage, hospitals commonly offer sign-on bonuses of up to \$15,000 to recruit nurses and referral bonuses of up to \$5,000. A successful referral usually means that companies award bonuses only if hired referrals remain employed with the company in good standing beyond a designated period, often at least 30 days. Referral plans rely on the idea that current employees' familiarity with company culture should enable them to identify viable candidates for job openings more efficiently than employment agencies could because agents are probably less familiar with client companies' cultures. Employees are likely to make only those referrals they truly believe are worthwhile because their personal reputations are at stake.

Individual incentive plans have advantages and disadvantages. On the positive side, individual incentive plans promote an equitable distribution of compensation within companies (i.e., the amount employees earn depends on their job performance). The better employees perform, the more they earn. Equitable pay ultimately enables companies to retain the best performers. Paying better performers more money sends a signal that the company appropriately values positive job performance. Another advantage of individual incentive plans is their compatibility with such individualistic cultures as the United States. Because U.S. employees are socialized to make individual contributions and be recognized for them, the national culture of the United States probably enhances the motivational value of individual incentive programs.

A downside of individual incentive plans is that they may encourage undesirable workplace behavior when these plans reward only one or a subset of dimensions that constitute employees' total job performance. Let's assume that an incentive plan rewards employees for quantity of output. If employees' jobs address such various dimensions as quantity of output, quality, and customer satisfaction, employees may focus on the one dimension—in this case, quantity of output—that leads to incentive pay and thereby neglect the other dimensions.

GROUP INCENTIVE PLANS In baseball, as with other team sports, you do not judge the team based on its ace pitcher or great outfielder. The criterion for success is overall team performance, its win-loss record. In business, companywide plans offer a possible alternative to the incentive plans previously discussed. *Team-based incentives* are determined by how well the team performs in the accomplishment of the job. Because team performance consists of individual efforts, individual employees should be recognized and rewarded for their contributions. However, if a team is to function effectively, firms should also provide a reward based on the overall team performance as well. Changing a firm's compensation structure from an individual-based system to one that involves team-based pay can have powerful results. By so doing, a firm can improve efficiency, productivity, and profitability.

There are many kinds of team incentive programs. Most companies define these programs based on the type of team:²⁵ Work (process) teams refer to organizational units that perform the work of the organization on an ongoing basis. Membership is relatively permanent, and members work full time on the team. Customer service teams and assembly teams on production lines represent excellent examples of work teams. Work teams are effective when individuals are cross-trained to perform team members' work when they are absent. The goal is to maintain consistency in performance quality (e.g., addressing customer concerns promptly even when

one or more team members are absent) and output (e.g., in the case of assembly teams). Team members ultimately engage in performance sharing rather than focusing exclusively on one set of tasks.

Project teams consist of a group of people assigned to complete a one-time project. Members usually have well-defined roles and may work on specific phases of the project, either full time or in addition to other work responsibilities of the team. Project teams usually work across such functions as engineering, product development, and marketing to ensure that the final product meets company specifications in terms of cost, quality, and responsiveness to market demands (e.g., Toyota's hybrid vehicles). Many individuals collaborated to ensure the production of cars that rely less on fossil fuels, demonstrate excellent gas mileage, and offer the same driving experience that people have come to expect of gasoline-powered automobiles.

Parallel teams, or task forces, include employees assigned to work on a specific task in addition to normal work duties. The modifier *parallel* indicates that an employee works on the team task while continuing to work on normal duties. Also, parallel teams or task forces operate on a temporary basis until their work culminates in a recommendation to top management. Task forces are used to evaluate existing systems and processes, to select new technology, and to improve existing products. People often serve on a voluntary basis or are appointed; in many cases, they are not compensated specifically for extra work or outcome of extra work.

Teams or groups may ultimately receive incentive pay based on such criteria as customer satisfaction (i.e., customer service quality), safety records, quality, and production records. Although these criteria apply to other categories of incentive programs as well (individual, companywide, and group plans), companies allocate awards to each worker based on the group's attainment of predetermined performance standards.

Team incentives have both advantages and disadvantages. On the positive side, firms find it easier to develop performance standards for groups than for individuals. For one thing, there are fewer standards to determine. Also, the output of a team is more likely to reflect a complete product or service. Another advantage is that employees may be more inclined to assist others and work collaboratively if the organization bases rewards on the team's output. When teams perform highly, it is the interaction among team members, not the members themselves, that creates the high performance. If a team member is asked who was responsible for the high performance of the team, he or she would likely say "We were" and mean it. A potential disadvantage for team incentives relates to exemplary performers. If individuals in this category perceive that they contribute more than other employees in the group, they may become disgruntled and leave. Christopher Avery, a Texas-based speaker and consultant who specializes in issues concerning individual and shared responsibility in the workplace and the author of *Teamwork Is an Individual Skill: Getting Your Work Done When Sharing Responsibility*, said, "If management wants to reward a high-performing team member, give that person a raise."²⁶

Gain sharing plans are designed to bind employees to the firm's productivity and provide an incentive payment based on improved company performance. Gain sharing programs, such as the Scanlon, Rucker, and Improshare plans, are the most popular companywide plans that have been adopted by U.S. corporations. The goal of gain sharing is to focus on improving cost-efficiency, reducing costs, improving throughput, and improving profitability. Gain sharing helps align an organization's people strategy with its business strategy. Gain sharing plans (also known as *productivity incentives*, *team incentives*, and *performance sharing incentives*) generally refer to incentive plans that involve many or all employees in a common effort to achieve a firm's performance objectives.

Joseph Scanlon, after whom the Scanlon plan was named, developed the first gain sharing plan during the Great Depression, and it continues to be a successful approach to group incentive. The **Scanlon plan** provides a financial reward to employees for savings in labor costs resulting from their suggestions. Employee-management committees evaluate these suggestions. Participants in these plans calculate savings as a ratio of payroll costs to the sales value of what that payroll produces. If the company is able to reduce payroll costs through increased operating efficiency, it shares the savings with its employees. Scanlon plans are not only financial incentive systems, but

gain sharing

Plans designed to bind employees to the firm's productivity and provide an incentive payment based on improved company performance.

Scanlon plan

Gain sharing plan that provides a financial reward to employees for savings in labor costs resulting from their suggestions.



HR BLOOPERS

Motivating Software Development Teams

As she gets ready to start her presentation, Jennifer Senders is excited about her new plan to improve performance of the software development teams at Creators Software. As a Senior Compensation Analyst, she was charged with creating a new team-based pay plan to replace the company's current individual bonus system. All of the software developers at Creators work in teams to design and deliver software solutions for a wide variety of clients. The workforce at Creators is very talented, but many of the developers would prefer to work alone. As a result, many of the teams were having problems meeting deadlines and other expected

team outcomes. Jennifer knows that for the team to work well together, the incentives should focus on team goals instead of individual goals. However, a glance at her audience as she explains the new bonus structure suggests they may not share her enthusiasm. She gets a hint about their concerns as soon as she asks for questions. Several hands go up and the employees begin to ask about individual rewards. One developer states that he knows he works harder than others on his team and he doesn't want them affecting his pay. As Jennifer starts to respond, she is thinking fast about what she might need to change.

★ If your professor has assigned this, go to mymanagementlab.com to complete the HR Bloopers exercise and test your application of these concepts when faced with real-world decisions.



HR Web Wisdom

Scanlon Leadership Network
<http://www.scanlon.org/>

A promoter of the Scanlon principles to advance their applications among organizations.

profit sharing

Compensation plans that result in the distribution of a predetermined percentage of the firm's profits to employees.

vesting

An employee's acquired nonforfeitable rights to pension benefits.

also systems for participative management. The Scanlon plan embodies management-labor cooperation, collaborative problem solving, teamwork, trust, gain sharing, open-book management, and servant leadership.

COMPANYWIDE INCENTIVE PLANS The use of companywide incentive plans can be traced to the nineteenth century. Companies instituted profit sharing programs to ease workers' dissatisfaction with low pay and to change their beliefs that company management paid workers substandard wages while earning substantial profits. Quite simply, management believed that workers would be less likely to challenge managerial practices if they received a share of company profits. Organizations normally base companywide plans on the firm's profitability or market value. Companywide plans include profit sharing and employee stock option plans.

Profit sharing is a compensation plan that results in the distribution of a predetermined percentage of the firm's profits to employees. Many firms use this type of plan to integrate the employees' interests with those of the company. Profit-sharing plans can aid in recruiting, motivating, and retaining employees, which usually enhances productivity.

There are several variations of profit-sharing plans, but three basic kinds of plans used today are current profit sharing, deferred profit sharing, and combination plans.

- *Current plans* provide payment to employees in cash or stock as soon as profits have been determined.
- *Deferred plans* involve placing company contributions in an irrevocable trust, credited to individual employees' accounts. The funds are normally invested in securities and become available to the employee (or his or her survivors) at retirement, termination, or death.
- *Combination plans* permit employees to receive payment of part of their share of profits on a current basis, while deferring payment of part of their share.

Normally, most full-time employees are included in a company's profit-sharing plan after a specified waiting period. **Vesting** determines the amount of company profit an employee owns in his or her account. Firms often determine this sum on a graduated basis. For example, an employee may become 25 percent vested after being in the plan for two years; 50 percent vested after three years; 75 percent vested after four years; and 100 percent vested after five years. This gradual approach to vesting encourages employees to remain with the firm, thereby reducing turnover.

The results of profit sharing include increased efficiency and lower costs. However, variations in profits may present a special problem. When employees have become accustomed to receiving added compensation from profit sharing, and then there is no profit to share, they may become disgruntled.

employee stock plans

The right to purchase shares of company stock.

company stock

The total equity or worth of the company.

company stock shares

Equity segments of equal value, which increase with the number of stock shares held.

stock option plan

Incentive plan in which employees can buy a specified amount of stock in their company in the future at or below the current market price.

employee stock option plan (ESOP)

Plan in which a firm contributes stock shares to a trust, which then allocates the stock to participating employee accounts according to employee earnings.

stock compensation plans

Companywide incentive plans that grant employees the right to purchase shares of company stock.

deferred compensation

An agreement between an employee and a company to render payments to an employee at a future date.

job-based pay

Employee compensation for jobs employees currently perform.

person-focused pay

Compensation for developing the flexibility, knowledge, and skills to perform a number of jobs effectively.

skill-based pay

System that compensates employees for their job-related skills and knowledge, not for their job titles.

A basic problem with a profit-sharing plan stems from the recipients' seldom knowing precisely how they helped generate the profits, beyond just doing their jobs. HR professionals refer to this as a line-of-sight problem. And, if employees continue to receive a payment, they will come to expect it and depend on it. If they do not know what they have done to deserve it, they may view it as an entitlement program and the intended ownership attitude may not materialize.

Under **employee stock plans**, companies grant employees the right to purchase shares of company stock. **Company stock** represents total equity of a company. **Company stock shares** represent equity segments of equal value. Equity interest increases positively with the number of stock shares. **Stock options** describe an employee's right to purchase company stock. Employees do not actually own stock until they exercise the stock option rights. This is done by purchasing stock at a designated price after a company-chosen time period lapses, usually no more than 5 years. Employee stock options provide an incentive to work productively, with the expectation that collective employee productivity will increase the value of company stock over time. Employees earn monetary compensation when they sell the stock at a higher price than they originally paid for it.

Employee stock option plans represent just one type of general stock compensation plan. Two other basic kinds of stock plans are widely used today. First, **employee stock ownership plans (ESOPs)** place company stock in trust accounts for employees. The purpose of ESOPs is similar to deferred profit sharing because these trusts are set aside on employees' behalf as a source of retirement income and these awards provide favorable treatment to employees. Second, **stock compensation plans** represent an important type of deferred compensation for executives. **Deferred compensation** is supposed to create a sense of ownership, aligning the interests of the executive with those of the owners or shareholders of the company over the long term.

Person-Focused Pay

Thus far, we have studied job-based pay practices. **Job-based pay** compensates employees for jobs they currently perform. HR professionals establish a minimum and maximum acceptable amount of pay for each job. In the case of merit pay, managers evaluate employees based on how well they fulfilled their designated roles as specified by their job descriptions and periodic objectives. Managers then award a permanent merit addition to base pay, based on employee performance. With incentive pay, managers award one-time additions to base pay. Pay raise amounts are based on the attainment of work goals, which managers communicate to employees in advance.

In contrast, **person-focused pay** compensates employees for developing the flexibility, knowledge, and skills to perform a number of jobs effectively. Moreover, these programs reward employees on their *potential* to make positive contributions to the workplace based on their successful acquisition of work-related skills or knowledge. Job-based pay plans reward employees for the work they have done as specified in their job descriptions or periodic goals (i.e., how well they have fulfilled their potential to make positive contributions in the workplace).

Skill-based pay is a system that compensates employees for their job-related *skills* and *knowledge*, rather than how well he or she performs on the present job. Skill-based pay is a method of recruiting and retaining highly skilled employees that enables employers to offer compensation based on the knowledge, skills, and abilities that employees bring to the company and that they develop over the course of their employment, rather than based solely on the duties associated with a position.²⁷ Essentially, job descriptions, job evaluation plans, and job-based salary surveys are replaced by skill profiles, skill evaluation plans, and *skill-based* salary surveys. The system assumes that employees who know more are more valuable to the firm and, therefore, they deserve a reward for their efforts in acquiring new skills. When employees obtain additional job-relevant skills, both individuals and the departments they serve benefit. For example, a department may have six different types of machines, each requiring different skills to operate. Under a skill-based pay system, the worker would increase his or her pay as additional machines are learned.

Although skill-based pay appears to have advantages for both employer and employee, there are some challenges for management. The firm must provide adequate training opportunities or else the system can become a demotivator. Also, because it takes an average of only three years

Interindustry differentials can be attributed to a number of factors, including the industry's product market, the degree of capital intensity, the profitability of the industry, unionization, and gender mix of the workforce.³⁰ Companies that operate in product markets in which there is relatively little competition from other companies tend to pay higher wages because these companies exhibit substantial profits. This phenomenon can be attributed to such factors as higher barriers to entry into the product market and an insignificant influence of foreign competition. Government regulation and extremely expensive equipment represent entry barriers in such industries as mining. The U.S. defense industry and the public utilities industry have high entry barriers and no threats from foreign competitors.

Capital intensity also explains pay differentials between industries. The amount of average pay varies with the degree of capital intensity. On average, capital-intensive industries such as construction pay more than industries that are less capital intensive such as retail. Capital-intensive businesses require highly capable employees who have the aptitude to learn how to use complex technology. Service such as retail industries are not capital intensive, and most have the reputation of paying low wages. The operation of service industries depends almost exclusively on employees with relatively common skills rather than on employees with specialized skills to operate such physical equipment as casting machines or robotics.

Legislation

Federal and state laws can also affect the amount of compensation a person receives and how that amount is determined. For example, prevailing wage laws specify how pay rates should be calculated. The Equal Pay Act prohibits an employer from paying an employee of one gender less money than an employee of the opposite gender, if both employees do work that is substantially the same. Equal employment legislation, including the Civil Rights Act, the Age Discrimination in Employment Act, and the Americans with Disabilities Act, prohibits discrimination against specified groups in employment matters, including compensation. The same is true for federal government contractors or subcontractors covered by Executive Order 11246 and the Rehabilitation Act. States and municipal governments also have laws that affect compensation practices. Our focus in the next section, however, is on the federal legislation that provides broad coverage and specifically deals with compensation issues. These laws appear in chronological order of their passage.

DAVIS-BACON ACT OF 1931 The Davis-Bacon Act of 1931 was the first national law to deal with minimum wages. It mandates a *prevailing wage* for all federally financed or assisted construction projects exceeding \$2,000. Contractors must pay wages at least equal to the prevailing wage in the local area. The U.S. Secretary of Labor determines prevailing wage rates based on compensation surveys of different areas. In this context, "local" area refers to the general location where work is performed. Cities and counties represent local areas. The "prevailing wage" is the typical hourly wage paid to more than 50 percent of all laborers and mechanics employed in the local area. The act also requires that contractors offer fringe benefits that are equal in scope and value to fringe compensation that prevails in the local area.

WALSH-HEALY ACT OF 1936 The Walsh-Healy Act covers contractors and manufacturers who sell supplies, materials, and equipment to the federal government. Its coverage is more extensive than the Davis-Bacon Act. This act applies to both construction and nonconstruction activities. In addition, this act covers all of the contractors' employees except office, supervisory, custodial, and maintenance workers who do any work in preparation for the performance of the contract. The minimum contract amount that qualifies for coverage is \$10,000 rather than the \$2,000 amount under the Davis-Bacon Act of 1931. This legislation also requires one-and-a-half times the regular pay rate for hours more than 8 per day or 40 per week.

FAIR LABOR STANDARDS ACT OF 1938, AS AMENDED The most significant law affecting compensation is the Fair Labor Standards Act (FLSA) of 1938. The purpose of the FLSA is to establish minimum labor standards on a national basis and to eliminate low wages and long working hours. The FLSA attempts to eliminate low wages by setting a minimum wage and to make long hours expensive by requiring a higher overtime pay rate for excessive hours. It also requires record keeping and provides standards for child labor. The Wage and Hour Division of

the U.S. Department of Labor (DOL) administers this act. The amount of the minimum wage has changed several times since it was first introduced in 1938 and continues to do so; it rose from \$6.55 to \$7.25 per hour in 2009.

Even though the federal and some state governments raise the minimum wage from time to time, most workers who earn the minimum wage argue that it is insufficient to afford the basic necessities. In the summer of 2013, fast food workers across the United States walked off their jobs to protest against what they believe is insufficient pay. The following Watch It video captures workers' concerns about the minimum wage level and the collective response of restaurant owners to their concerns.

★ Watch It 2

If your professor has assigned this, sign into mymanagementlab.com to watch a video titled *Fast Food Workers Walk Out, Demanding Higher Pay* and to respond to questions.

Tipped workers, on the other hand, may receive an hourly minimum wage of \$2.13.³¹ However, if hourly wage plus tips do not add up to the minimum wage (\$7.25 per hour), the company must make up the difference. It is here that minimum-wage violations often occur.³² In 2014, the Internal Revenue Service (IRS), which is the government agency that creates and enforces tax regulations, instituted a change in the taxation of tips that are automatically added to the bill by the restaurant. Until then, companies paid the entire amount to its servers and the IRS expected that servers would report tips as income for taxation purposes. We simply do not know whether servers routinely report all, some, or none of their tips to the IRS for taxation. Now, companies are required to withhold taxes from tips before distributing them to employees. This policy change will substantially increase restaurants' paperwork and likely reduce servers' income.³³

The act distinguishes between exempt and nonexempt employees for the purposes of determining which employees are required to be paid an overtime rate of one-and-one-half times the employee's regular rate after 40 hours of work in a 168-hour period. Companies are not required to pay overtime to exempt employees, but they are required to do so for nonexempt employees. **Exempt employees** are categorized as executive, administrative, professional, or outside salespersons. All others are **nonexempt employees**. Aggressive action is being taken against companies that fail to pay the overtime requirement.³⁴ Although the act covers most organizations and employees, certain classes of employees are specifically exempt from overtime provisions.

An executive employee is essentially a manager (such as a production manager) with broad authority over subordinates. An administrative employee, although not a manager, occupies an important staff position in an organization and might have a title such as account executive or market researcher. A professional employee performs work requiring advanced knowledge in a field of learning, normally acquired through a prolonged course of specialized instruction.³⁵ This type of employee might have a title such as company physician, legal counsel, or senior statistician. Outside salespeople sell tangible or intangible items away from the employer's place of business.

EQUAL PAY ACT OF 1963 Congress enacted the Equal Pay Act of 1963 to remedy a serious problem of employment discrimination in private industry: "Many segments of American industry [have] been based on an ancient but outmoded belief that a man, because of his role in society, should be paid more than a woman even though his duties are the same."³⁶ The Equal Pay Act of 1963 is based on a simple principle: Men and women should receive equal pay for performing equal work.

The Equal Pay Act of 1963 pertains explicitly to jobs of equal worth. Companies assign pay rates to jobs according to the skill, effort, responsibility, and working conditions required.

Pay differentials for equal work are not always illegal. Pay differentials between men and women who are performing equal work are acceptable only when made on a seniority system, merit system, incentive system, or on any factor other than sex.

exempt employees

Employees categorized as executive, administrative, professional, or outside salespersons, and not required to be paid at an overtime rate for work beyond the completion of standard work hours.

nonexempt employees

Employees not categorized as executive, administrative, professional, or outside salespersons, and required to receive overtime pay for work beyond the completion of standard work hours.

It is essential that sound performance appraisal practices be in place for the many reasons we discussed in Chapter 7, performance appraisal practices are essential to determine whether pay differentials between men and women performing equal work are illegal.

WALL STREET REFORM AND CONSUMER PROTECTION ACT (DODD-FRANK ACT) The Dodd-Frank Act was signed into law in 2010 and has provisions relating to executive compensation and corporate governance that impact the executives, directors, and shareholders of publicly traded companies. We will cover specific provisions of the act in the discussion about executive compensation, which follows later in this chapter.

OBJECTIVE 9.5

Describe how to use job evaluation to build job structures.

job structure

An ordered set of similar jobs based on worth.

job evaluation

Process that determines the relative value of one job in relation to another.

Build Job Structures Using Job Evaluation

A **job structure** is an ordered set of jobs that represents the job structure or hierarchy. That is, jobs that require higher qualifications, more responsibilities, and more complex job duties should be paid more than jobs that require lower qualifications, fewer responsibilities, and less-complex job duties. Internally consistent job structures formally recognize differences in job characteristics that enable compensation managers to set pay accordingly. HR professionals use **job evaluation** systematically to recognize differences in the relative worth among a set of jobs and to establish pay differentials accordingly.

When done properly, job evaluation helps to eliminate internal pay inequities that exist because of illogical pay structures. For example, pay inequity probably exists if the mailroom supervisor earns more than the chief accountant. For obvious reasons, organizations prefer internal pay equity. However, when a job's pay rate is ultimately determined to conflict with the market rate, the latter is almost sure to take precedence. Job evaluation measures job worth in an administrative rather than an economic sense. The latter can be determined only by the marketplace and made known through compensation surveys.³⁷ We will discuss compensation surveys later in this chapter.

The HR department may be responsible for administering job evaluation programs. However, committees made up of individuals familiar with the specific jobs to be evaluated often perform the actual evaluations. A typical committee might include the HR executive and representatives from other functional areas such as finance, production, information technology, and marketing. The composition of the committee usually depends on the type and level of the jobs being evaluated. In all instances, it is important for the committee to keep personalities out of the evaluation process and to remember that it is evaluating the job, not the person(s) performing the job. Some people have difficulty making this distinction. This is understandable because some job evaluation systems are similar to some performance appraisal methods. In addition, the duties of a job may, on an informal basis, expand, contract, or change depending on the person holding the job.

The four traditional job evaluation methods are the *ranking*, *classification*, *factor comparison*, and *point*. There are innumerable versions of these methods, and a firm may choose one and modify it to fit its particular purposes. Another option is to purchase a proprietary method such as the Hay Plan. The ranking and classification methods are nonquantitative, whereas the factor comparison and point methods are quantitative approaches.

Ranking Method

The ranking method is the simplest of the four job evaluation methods. In the **job evaluation ranking method**, the raters examine the description of each job being evaluated and arrange the jobs in order according to their value to the company. The procedure is essentially the same as the ranking method for evaluating employee performance. The only difference is that you evaluate jobs, not people.

Classification Method

The **classification method** involves defining a number of classes or grades to describe a group of jobs. In evaluating jobs by this method, the raters compare the job description with the class description. Class descriptions reflect the differences between groups of jobs at various difficulty

job evaluation ranking method

Job evaluation method in which the raters examine the description of each job being evaluated and arrange the jobs in order according to their value to the company.

classification method

Job evaluation method in which classes or grades are defined to describe a group of jobs.



HR Web Wisdom

*The Hay Group Guide
Chart-Profile Method*
<http://www.haygroup.com>

Homepage of the Hay Plan, the most widely used job measurement system in the world, is provided.

factor comparison method

Job evaluation method that assumes there are five universal factors consisting of mental requirements, skills, physical requirements, responsibilities, and working conditions; the evaluator makes decisions on these factors independently.

point method

Job evaluation method in which the raters assign numerical values to specific job factors, such as knowledge required, and the sum of these values provides a quantitative assessment of a job's relative worth.

compensation policy

Policies that provide general guidelines for making compensation decisions.

pay level compensation policies

Determine whether the company will be a pay leader (market lead), a pay follower (market lag), or assume an average position (market match) in the labor market.

OBJECTIVE 9.6

Describe various competitive compensation policies.

pay mix compensation policies

Combination of direct (core compensation) and indirect financial compensation (employee benefits) components that make up an employee's total compensation package.

levels. The class description that most closely agrees with the job description determines the classification for that job. For example, in evaluating the job of receptionist, the description might include these duties:

- Greet and announce visitors.
- Answer phone and route calls.
- Receive and route mail.

Assuming that the remainder of the job description includes similar routine work, this job would probably be placed in the lowest job class.

Each class is described in such a way that it captures sufficient work detail, yet is general enough to cause little difficulty in slotting a job description into its appropriate class.

Factor Comparison Method

The factor comparison method is somewhat more involved than the two previously discussed qualitative methods. The **factor comparison method** of job evaluation assumes that there are five universal factors consisting of mental requirements, skills, physical requirements, responsibilities, and working conditions; the evaluator makes decisions on these factors independently.

The five universal job factors are:

- *Mental requirements*, which reflect mental traits such as intelligence, reasoning, and imagination.
- *Skills*, which pertain to facility in muscular coordination and training in the interpretation of sensory impressions.
- *Physical requirements*, which involve sitting, standing, walking, lifting, and so on.
- *Responsibilities*, which cover areas such as raw materials, money, records, and supervision.
- *Working conditions*, which reflect the environmental influences of noise, illumination, ventilation, hazards, and hours.

In this method, the evaluation committee creates a monetary scale, containing each of the five universal factors, and ranks jobs according to their value for each factor. Unlike most other job evaluation methods, which produce relative job worth only, the factor comparison method determines the absolute value as well.

Point Method

In the **point method**, raters assign numerical values to specific job factors, such as knowledge required, and the sum of these values provides a quantitative assessment of a job's relative worth. Historically, some variation of the point plan has been the most popular option.

Point plans require time and effort to design. A redeeming feature of the method has been that, once developed, the plan was useful over a long time. In today's environment, the shelf life may be considerably less. In any event, as new jobs are created and old jobs substantially changed, job analysis must be conducted and job descriptions rewritten on an ongoing basis. The job evaluation committee then evaluates the jobs. Only when job factors change, or for some reason the weights assigned become inappropriate, does the plan become obsolete.

Competitive Compensation Policies

A **compensation policy** refers to choices that compensation professionals make to promote competitive advantage. Broadly, policy choices are made about pay level and pay mix. **Pay level compensation policies** determine whether the company will be a pay leader, be a pay follower, or strive for an average position in the labor market. Pay level policies have the greatest impact on attracting and retaining employees. **Pay mix compensation policies** refer to the combination of direct and indirect financial compensation and employee benefits components (see Figure 9-1) that make up an employee's compensation package. Pay mix policies have the greatest impact on motivating employees. The components of the compensation package help focus an employee's performance on what the employer expects, such as excellent customer service, sales, innovative use of technology, and so forth.

Pay Level Compensation Policies

We will review the three pay level policies followed by pay mix. Figure 9-5 illustrates the market lead, market match, and market lag pay level policies.

market lead policies
 Pay policy that distinguishes companies from the competition by compensating employees more highly than most competitors. Leading the market denotes market levels above the market pay line.

market match policy
 Average pay that most employers provide for a similar job in a particular area or industry.

market lag policies
 Pay policy that distinguishes companies from the competition by compensating employees less than most competitors. Lagging the market indicates that market levels fall below the market pay line.

MARKET LEAD Companies that pursue a **market lead policy** are organizations that pay higher wages and salaries than competing firms. Using this strategy, they feel that they will be able to attract high-quality, productive employees and thus achieve lower per-unit labor costs. Higher-paying firms usually attract more highly qualified applicants than lower-paying companies in the same labor market. The Mayo Clinic, headquartered in Rochester, Minnesota, is a pay leader.³⁸ The Mayo Clinic is known for its leading research and medical care, which requires it to hire and retain bright and talented researchers and medical practitioners.

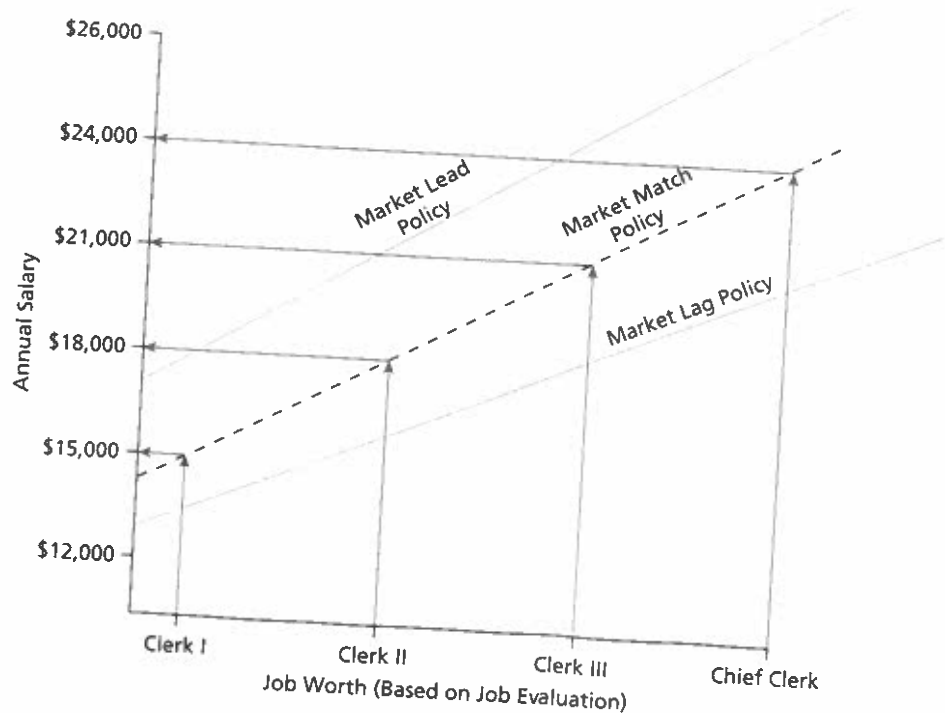
MARKET MATCH The **market match policy** is the average pay that most employers provide for a similar job in a particular area or industry. Many organizations have a policy that calls for paying the market rate. In such firms, management believes that it can still employ qualified people and remain competitive.

MARKET LAG Companies may choose to pay below the market rate (**market lag policy**) because of poor financial conditions or because they are hiring employees whose skills and expected impact on the company's success are relatively lower than employees whose skills and expected impact are much greater. For example, in pharmaceutical companies that rely heavily on research and development, janitorial services workers might receive below-market pay rates compared to research scientists who are directly responsible for the firm's success through innovative product development.

Besides the considerations already discussed, two additional issues bear mention. First, most companies do not pursue a single pay level policy. As emphasized in the market lag discussion, the relative importance of jobs to the company and the level of knowledge and skills required to perform the jobs influence pay policy level choices. Second, the principle of labor supply and demand factor into companies' decisions about which pay policy levels to choose. For example, companies will likely choose the pay leader policy for jobs that are in high demand by companies, but for which jobs are in relatively low supply. Consider the case of biomedical engineers.

Employment of biomedical engineers is projected to grow by 62 percent from 2010 to 2020, much faster than the average for all occupations. However, because it is a small occupation, the fast growth will result in only about 9,700 new jobs over the 10-year period.

FIGURE 9-5
Pay Level Policy



The aging baby-boom generation is expected to increase demand for biomedical devices and procedures, such as hip and knee replacements, because this generation seeks to maintain its healthy and active lifestyle. Additionally, as the public has become aware of medical advances, increasing numbers of people are seeking biomedical advances for themselves from their physicians.

Biomedical engineers will likely experience more demand for their services because of the breadth of activities they engage in, made possible by the diverse nature of their training.

Biomedical engineers work with medical scientists, other medical researchers, and manufacturers to address a wide range of injuries and physical disabilities. Their ability to work in different activities with other professionals is enlarging the range of applications for biomedical engineering products and services, particularly in healthcare.³⁹

Pay Mix

As noted earlier, pay mix compensation policies refer to the combination of direct and indirect financial compensation and employee benefits components (see Figure 9-1) that make up an employee's compensation package. Pay policy mix may be expressed in dollars (or other currency as relevant) or as a percentage of total dollars allocated for an employee's total compensation. Figure 9-6 illustrates an example of a pay policy mix.

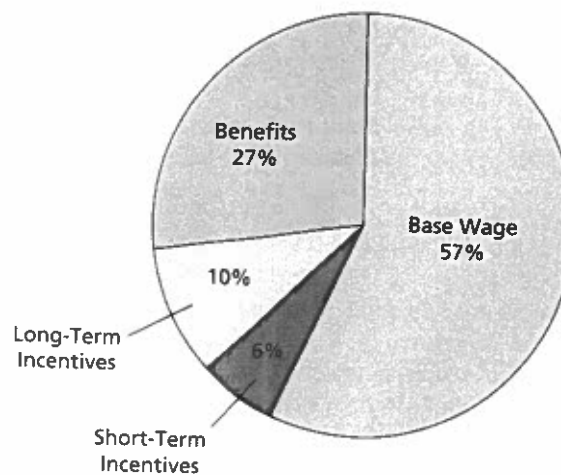
This example indicates that base pay accounts for 57 percent of the money allocated to an employee's total compensation. Let's assume that the company spends \$200,000 annually to fund a particular employee's total compensation package. Of the total, an employee receives base pay in the amount of \$114,000 (that is, $\$200,000 \times 57$ percent).

What is an appropriate pay mix? For policy purposes, it makes sense to consider guidelines for jobs within a particular structure (for example, managerial, administrative, or sales) because of the common job content and worker requirements of jobs within a particular structure. For example, in a technology company, a greater portion of incentive compensation might be allocated to engineers than to administrative staff. Engineers possess crucial skills relating to the company's ability to find innovative applications of technology, and bonus incentives throughout the year may promote innovation initiatives. On the other hand, the administrative staff, though important to the company, may not play as important a role in determining the company's profitability or objectives. Therefore, less of their total compensation would likely be devoted to incentive awards. Also, some employees, such as sales, may receive the majority of their compensation in the form of incentive pay. To motivate a sales force to continually exceed quarterly targets, quarterly bonuses equal to or exceeding their annual base salaries might be used.

Ability to Pay

An organization's assessment of its ability to pay is also an important factor in determining pay levels. Financially successful firms tend to provide higher-than-average compensation. However, an organization's financial strength establishes only the upper limit of what it will pay. To arrive at a specific pay level, management must consider other factors.

FIGURE 9-6
Pay Mix Policy



OBJECTIVE 9.7

Explain the use of compensation surveys for job pricing and determining market competitive pay structures

pay structures

Pay rate differences for jobs of unequal worth and the framework for recognizing differences in employee contributions.

compensation survey

A means of obtaining data regarding what other firms are paying for specific jobs or job classes within a given labor market.

pay grade

Grouping of similar jobs to simplify pricing jobs.

Market Competitive Pay Structures: Job Pricing Using Compensation Surveys

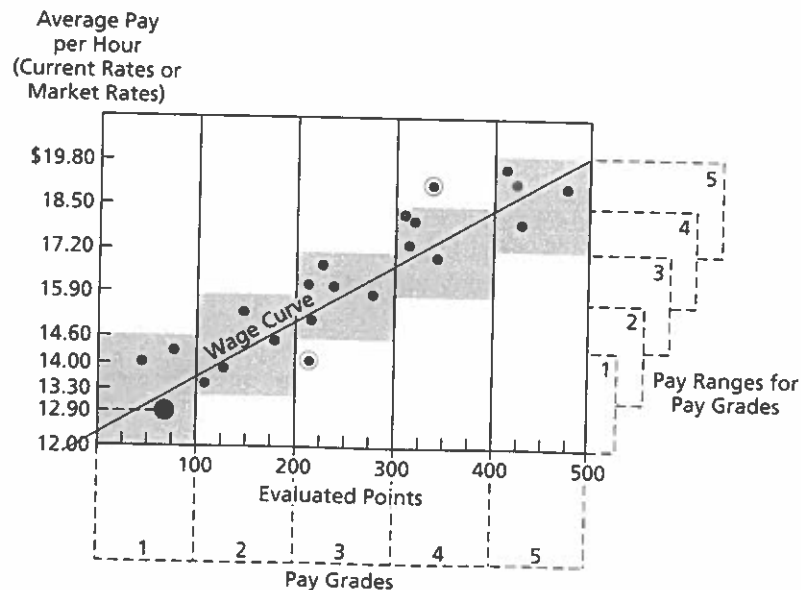
Pay structures represent pay rate differences for jobs of unequal worth and the framework for recognizing differences in employee contributions. These structures result from an analysis based on compensation survey work. **Compensation surveys** involve the collection and subsequent analysis of competitors' compensation data. Compensation surveys traditionally focused on competitors' wage and salary practices. Employee benefits have more recently also become a target of surveys because benefits are a key element of market-competitive pay systems. Compensation surveys are important because they enable compensation professionals to obtain realistic views of competitors' pay practices. Companies recognize these differences by paying individuals according to their credentials, knowledge, or job performance. When completed, pay structures should define the boundaries for recognizing employee contributions. Well-designed structures should promote the retention of valued employees. Pay grades and pay ranges are structural features of pay structures.

Pay Grades

A **pay grade** is the grouping of similar jobs to simplify pricing jobs. For example, it is much more convenient for organizations to price 15 pay grades than 200 separate jobs. The simplicity of this approach is similar to a college or university's practice of grouping grades of 90–100 into an A category, grades of 80–89 into a B, and so on. In following this approach, you also avoid a false suggestion of preciseness. Although job evaluation plans may be systematic, none are scientific.

Plotting jobs on a scatter diagram is often useful to managers in determining the appropriate number of pay grades for a company. Looking at Figure 9-7, notice that each dot on the scatter diagram represents one job. The location of the dot reflects the job's relationship to pay and evaluated points, which reflects its worth. When this procedure is used, a certain point spread determines the width of the pay grade (100 points in this illustration). Although each dot represents one job, it may involve dozens of individuals who have positions in that one job. The large

FIGURE 9-7
Scatter Diagram of Evaluated Jobs Illustrating the Wage Curve, Pay Grades, and Pay Ranges



Summary Evaluated Points	Pay Grade	Minimum	Pay Range Midpoint	Maximum
0-99	1	\$12.00	\$13.30	\$14.60
100-199	2	13.30	14.60	15.90
200-299	3	14.60	15.90	17.20
300-399	4	15.90	17.20	18.50
400-500	5	17.20	18.50	19.80

dot at the lower left represents the job of receptionist, evaluated at 75 points. The receptionist's hourly rate of \$12.90 represents either the average wage currently paid for the job or its market rate. This decision depends on how management wants to price its jobs.

wage curve

Fitting of plotted points to create a smooth progression between pay grades (also known as the pay curve).

A **wage curve** (or pay curve) is the fitting of plotted points to create a smooth progression between pay grades. The curve often equates to the market match policy. The line drawn minimizes the distance between all dots and the line; a line of best fit may be straight or curved. However, when the point system is used, a straight line is often the result, as in Figure 9-7. The use of statistical methods to determine the line is essential given the sheer number of data points (pay rates) collected during the compensation survey process.

Pay Ranges

pay range

Minimum and maximum pay rate with enough variance between the two to allow for a significant pay difference.

After pay grades have been determined, the next decision is whether all individuals performing the same job will receive equal pay or whether pay ranges should be used. A **pay range** includes a minimum and maximum pay rate with enough variance between the two to allow for a significant pay difference. Pay ranges are generally preferred over single pay rates because they allow a firm to compensate employees according to performance and length of service. Pay then serves as a positive incentive. When pay ranges are used, a firm must develop a method to advance individuals through the range. Companies typically use different range spreads for jobs that are more valuable to the company.

POINTS ALONG THE RANGE Referring again to Figure 9-6, note that anyone can readily determine the minimum, midpoint, and maximum pay rates per hour for each of the five pay grades. For example, for pay grade 5, the minimum rate is \$17.20, the midpoint is \$18.50, and the maximum is \$19.80. The minimum rate may be the *hiring-in* rate that a person receives when joining the firm, although in practice, new employees often receive pay that starts above this level. The maximum pay rate represents the maximum that an employee can receive for that job regardless of how well he or she performs the job.

PROBLEM OF TOPPING OUT A person at the top of a pay grade will have to be promoted to a job in a higher pay grade to receive a pay increase unless (1) an across-the-board adjustment is made or (2) the job is re-evaluated and placed in a higher pay grade. This situation has caused numerous managers some anguish as they attempt to explain the pay system to an employee who is doing a tremendous job but is at the top of a pay grade. Consider this situation:

Everyone in the department realized that Beth Smithers was the best administrative assistant in the company. At times, she appeared to do the job of three people. Bob Marshall, Beth's supervisor, was especially impressed. Recently, he had a discussion with the human resource manager to see what he could do to get a raise for Beth. After Bob described the situation, the human resource manager's only reply was, "Sorry, Bob. Beth is already at the top of her pay grade. There is nothing you can do except have her job upgraded or promote her to another position."

Situations like Beth's present managers with a perplexing problem. Many would be inclined to make an exception to the system and give Beth a salary increase. However, this action would violate a traditional principle, which holds that every job in the organization has a maximum value, regardless of how well an employee performs the job. The rationale is that making exceptions to the compensation plan would result in widespread pay inequities. Having stated this, today many organizations are challenging traditional concepts as they strive to retain top-performing employees.

RATE RANGES AT HIGHER LEVELS The rate ranges established should be large enough to provide an incentive to do a better job. At higher levels, pay differentials may need to be greater to be meaningful. There may be logic in having the rate range become increasingly wide at each consecutive level. Consider, for example, what a \$200-per-month salary increase would mean to a file clerk earning \$2,000 per month (a 10 percent increase) and to a senior cost accountant earning \$5,000 per month (a 4 percent increase). Assuming an inflation rate of 4 percent, the accountant's *real* pay would remain unchanged.

OBJECTIVE 9.8

Discuss compensation for sales professionals.

Sales Representative Compensation

Designing compensation programs for sales employees involves unique considerations. Bob Cartwright, SPHR, president and CEO of Texas-based Intelligent Compensation LLC, advises companies on sales strategies saying, "Understanding what the business needs are, where the gaps exist and what needs to be driven to get business from point A to point B—that's the key."⁴³ Proper ratio of base pay, commissions, and bonuses must be established. For this reason, this task may belong to the sales staff rather than to HR. Nevertheless, many general compensation practices apply to sales jobs. For example, job content, relative job worth, and job market value are all relevant factors.

The *straight salary* approach is one extreme in sales compensation. In this method, salespersons receive a fixed salary regardless of their sales levels. Organizations use straight salary primarily to emphasize product support after the sale. For instance, sales representatives who deal largely with the federal government on a continuous basis often receive this form of compensation.

At the other extreme is *straight commission*, in which the person's pay is totally determined as a percentage of sales. If the salesperson makes no sales, the individual receives no pay. On the other hand, highly productive sales representatives can earn a great deal of money under this plan.

Between these extremes are the endless varieties of *part-salary, part-commission* combinations. The possibilities increase when a firm adds various types of *bonuses* to the basic compensation package. The emphasis given to either commission or salary depends on several factors, including the organization's philosophy toward service, the nature of the product, and the amount of time required to close a sale.

★ Try It!

If your professor has assigned this, sign onto mymanagementlab.com to complete the Motivation simulation and test your application of these concepts when faced with real-world decisions.

OBJECTIVE 9.9

Discuss compensation for contingent workers.

Contingent Worker Compensation

As we discussed in Chapter 5, contingent workers are those who do not have an implicit or explicit contract for ongoing employment. Contingent workers are employed through an employment agency or on an on-call basis and often earn less than traditional employees. Flexibility and lower costs for the employer are key reasons for the growth in the use of contingent workers. An inherent compensation problem relates to internal equity. You may have two employees working side by side, one a contingent worker and the other a regular employee, performing the same or near identical tasks, and one makes more money than the other. In most cases, contingents earn less pay and are far less likely to receive health or retirement benefits than their permanent counterparts.⁴⁴ In March 2013, 74 percent of full-time workers were offered participation in a health insurance plan whereas only 24 percent of part-time workers were offered the same.⁴⁵ Similarly, 74 percent of full-time workers had access to retirement plans whereas this was the case for only 37 percent of part-time workers.

OBJECTIVE 9.10

Explain executive compensation and the various features of executive compensation packages.

Executive Compensation

Although there has been considerable discussion regarding what some say are excessive salaries by executives, one should remember that the skills possessed by company executives largely determine whether a firm will prosper, survive, or fail. A company's executive compensation program is a critical factor in attracting and retaining the best available talent. Thus, compensation programs need to be developed that motivate these executives to strive to achieve long-term success for the firm. The five main components of executive compensation packages include: base salary, bonuses and performance-based pay, stock option plans, perquisites (perks), and severance packages.

Base Salary

Although it may not represent the largest portion of the executive's compensation package, base salary is obviously important. It is a factor in determining the executive's standard of living. Salary also provides the basis for other forms of compensation; for example, it may determine the amount of bonuses and certain benefits. The U.S. tax law does not allow companies to deduct more than \$1 million of an executive's salary unless it is performance based and meets specified criteria.⁴⁶

Bonuses and Performance-Based Pay

As shareholders become increasingly disenchanted with the high levels of executive compensation for less-than-stellar accomplishments, performance-based pay is gaining in popularity. Although the Dodd-Frank Act has influenced executive pay, it appears that the greater influence has been the initiative to link pay to performance.⁴⁷ If pay for performance is appropriate for lower-level employees, should top executives be exempt from the same practice? The true superstars can still have huge earnings if their targets are met.

Payment of bonuses reflects a managerial belief in their incentive value. Cash bonuses, paid periodically based on performance goals, often provide real incentives. In the past, bonuses could be quite large and often were not tied to "real" performance goals. Hopefully, million-dollar pay packages not tied to performance are a thing of the past.

The Dodd-Frank Act requires the Securities and Exchange Commission (SEC) and other agencies to regulate incentive pay at financial institutions. The SEC requires that institutions with \$1 billion or more in assets (about 380 firms) be required to discourage "inappropriate risk" and disclose bonus details. Firms with \$50 billion in assets (about 30 firms) would have to defer at least half of the top executives' bonuses for three years. These mechanisms are designed to discourage short-term thinking.

Stock Option Plans

Stock option plans give the executive the option to buy a specified amount of stock in the future at or below the current market price. The stock option is a long-term incentive designed to integrate the interests of management with those of the organization. To ensure this integration, some boards of directors require their top executives to hold some of the firm's stock. Stock options have lost some of their appeal because of accounting rule changes that require companies to value and book an appropriate expense for options as they are granted. Nevertheless, there are several bona fide reasons for including stock ownership in executive compensation plans. In addition to potentially aligning employees' interests with those of shareholders, retaining top executives is also a factor.

Perquisites (Perks)

Perquisites (perks) are any special benefits provided by a firm to a small group of key executives and designed to give the executives "something extra." Possible executive's perks include a company-provided car, limousine service, and use of the company plane and yacht. The SEC has lowered the threshold for disclosure of executive perks from \$50,000 to \$10,000. Once-hidden information regarding perks must now be disclosed. Compensation committees are now focusing more on core incentives such as salaries, bonuses, and long-term incentives and cutting perks and severance pay. Perks such as having a corporate jet or yacht are things that upset the public and legislators. David E. Gordon of Frederic W. Cook & Co., a compensation consultancy, said, "These kinds of perks just aren't worth it. They are a small fraction of overall compensation but have the ability to get 50 percent of the attention."⁴⁸

A decrease in executive perquisites is a key prediction of the Dodd-Frank Act. In 2008, 60 percent of companies granted more than three perks to the top brass, whereas just 6 percent offered their senior managers zero perks. Five years later, just 33 percent offer three or more such extras, whereas a full 15 percent offer none at all.⁴⁹

Severance Packages

What most people may not understand is that massive severance payments are not set up by a board of directors after a CEO has quit or been fired. These payments were negotiated prior to being hired. Not only should CEO pay be considered but CEO pay contracts should also be examined. But hopefully the environment is changing.

Perquisites (Perks)

Special benefits provided by a firm to a small group of key executives and designed to give the executives something extra.

The SEC has adopted far-reaching executive compensation disclosure rules that apply to publicly traded companies. The new rules require companies to list all the agreements for each executive, to disclose the payment triggers, and, most importantly, to give an estimated dollar value of potential payments and benefits and the specific factors used to determine them. For the first time, investors will see the estimated total dollar value of the exit packages. No longer will these agreements become exposed only at the time of a merger and acquisition deal or when the board removes a CEO.

Executive Compensation Issues in the United States

For some time now, executive pay for the nation's highest-paid chief executives, including salary, bonuses, perks, and stock options, has been a lightning rod for criticism and debate.⁵⁰ In fact, every day there seems to be another story related to highly lucrative executive pay. The AFL-CIO, which is a federation of labor unions, has even set up an Executive PayWatch Web site. According to the site, CEOs of the top 299 companies in the Standard & Poor's 500 Index received, on average, \$12.3 million in total compensation in 2012. That is 354 times the average worker's median pay of \$34,645.⁵¹ Other studies have estimated the pay difference as even higher. No matter what figure is chosen, it is evident that the pay gap between the most affluent executives and the average worker has become enormous. It is difficult for workers who make \$12 to \$18 an hour to appreciate why these executives merit such large salaries. This obvious disparity has caused considerable discussion regarding the proper ratio of CEO compensation to that of the average worker.⁵²

Examples of lucrative executive compensation practices abound. For example, James J. Mulva, who stepped down as CEO of ConocoPhillips after 10 years, received an exit package worth \$157 million, which is the largest award in 2012. Much of the payout came from the market value of stock gains he received as well as payouts from a cash severance, a bonus, and additional retirement distributions.⁵³ Occidental Petroleum chief Ray Irani received a five-year total compensation of \$127,447,000. In 2006, thanks to a rise in oil prices and the company's payment scheme, Irani took home a total of \$460 million. In 2010, he took home nearly \$59 million in salary, perks, bonuses, and other stock awards.⁵⁴ Some CEOs, like Richard Fuld of Lehman Brothers, took home more pay, despite the fact that Lehman Brothers set a record as the largest bankruptcy.⁵⁵ The question of what is excessive compensation has emerged as the number one concern of shareholders.

There continues to be attempts to hold down executive salaries. However, sometimes it appears as though as soon as one compensation loophole is filled, another one emerges. IRS rules, for instance, state that performance-based compensation does not count toward the \$1 million maximum deduction that companies can take on compensation paid to top executives. Thus, there was an explosion in bonuses and deferred compensation. Once that loophole was defused, another one was found. IRS restrictions are relaxed once an executive has left the firm, so there was an increase in generous postretirement perks.⁵⁶

Many believe the Dodd-Frank Act will have a significant impact on executive compensation practices.⁵⁷ A recent sample survey suggests that the Dodd-Frank Act may already have an impact on CEO pay relative to company performance. This survey showed that more than half of the compensation awarded to CEOs in 2012 was tied to performance.⁵⁸ And some CEOs still receive compensation packages that most would perceive as excessive. Larry Ellison, CEO of Oracle, has accepted more than \$60 million in stock options every year since 2008. Apple's new CEO Tim Cook got a package worth \$378 million for his first year.⁵⁹

Air Products & Chemicals, Inc., maker of industrial gases, instituted a 65 percent cut in CEO John McGlade annual bonus in 2012 because company performance fell substantially below its growth target. In addition, a cut in stock options resulted in a reduction in total direct compensation by 19 percent.⁶⁰ Now if Air Products & Chemicals, Inc., does well in the long run, both McGlade and the company benefit.

Three provisions in the Dodd-Frank Act relate to say on pay, golden parachute contracts, and clawback policies.⁶¹ The provision for **say on pay** gives shareholders in all but the smallest companies an advisory vote on executive pay. This is something that governance advocates have long wanted. Those who support the concept of say on pay believe that the vote will cause greater accountability on executive pay decisions.⁶² The Dodd-Frank Act requires 5,000 companies to hold nonbinding shareholder say-on-pay votes at least every three years. Companies must also hold shareholder votes on the frequency of say on pay with the option of one, two, or three years, or to abstain. Frequency votes are required to be held every three years. Thus far,

say on pay
Provision that gives shareholders in all but the smallest companies an advisory vote on executive pay.

shareholder votes appear to be highly favorable in support of company pay plans. A survey by Semler Brossy revealed that 76 percent of companies have passed say on pay with more than 90 percent shareholder approval.⁶³ A recent study found that boards that give CEOs higher pay opportunities are more likely to receive lower levels of support in shareholder say-on-pay votes than those with lower CEO pay.⁶⁴ Also, shareholders appear to want their say on pay on an annual basis as opposed to every two or three years.⁶⁵ Institutional Shareholder Services (ISS), which recommends mutual funds and other large shareholders on how to vote in corporate elections, has recommended “no” votes on executive pay in about 13 percent of the proposals it has reviewed this proxy season.⁶⁶ All of the companies with a failed say-on-pay vote in 2012 had a negative recommendation from the proxy advisory firm ISS.⁶⁷ One major company to receive a negative vote on say on pay was Spectrum Pharmaceuticals. The negative vote may have been influenced by the high pay relative to shareholder return.⁶⁸

A **golden parachute contract** is a perquisite that protects executives in the event that another company acquires their firm or if the executive is forced to leave the firm for other reasons. To hire and retain talented individuals, some corporations negotiate employment agreements that include golden parachutes.⁶⁹ At times, golden parachute contracts have been abused. As an extreme example, CEO Robert Nardelli left Home Depot with a golden parachute worth \$210 million even though Home Depot’s stock performed poorly.⁷⁰

The Dodd–Frank Act has disclosure requirements for golden parachute arrangements between the companies and their executive officers. It requires a shareholder advisory vote on certain parachute arrangements where shareholder approval of the business combination itself is sought. Legally, a “no” vote has little effect because the vote is advisory, and the vote cannot bind a company or its board to overrule any company or board decision or change or add to the company’s or board’s duties. But from a shareholder relations viewpoint, the answer is more problematic. A “no” vote may indicate future shareholder involvement.⁷¹ Largely as a result of the Dodd–Frank Act, although golden parachutes continue to exist, many companies have scaled back the change-in-control severance payments to ward off shareholders’ concerns and line up with evolving best practices.⁷² Although golden parachutes are commonly used, mounting examples of shareholders’ rejections of these proposals is evident. For example, H. J. Heinz Company was sold to 3G Capital and Berkshire Hathaway. Heinz’s shareholders rejected a proposed golden parachute arrangement including \$56 million for chairman, president, and CEO Bill Johnson that included stock awards accelerated by the planned sale.⁷³ A **clawback policy** allows the company to recover compensation if a later review indicates that payments were not calculated accurately or performance goals were not met. The Dodd–Frank Act requires companies to develop clawback policies to recover compensation later deemed excessive.⁷⁴ The clawback is a procedure included in an executive’s employment contract that allows the company to recover payments made through performance-based incentives under certain circumstances.⁷⁵ It requires executives to return incentive pay if the results on which it was granted are later adjusted downward for any reason. The CEO of Atlanta-based homebuilder Beazer Homes paid back \$6.5 million in bonus pay and stock profits to settle an SEC complaint. According to the complaint, CEO Ian McCarthy failed to reimburse the company for cash bonuses, incentive and equity-based compensation, and profits from Beazer stock sales that he received in the year after the company filed fraudulent financial statements.⁷⁶

Executive Compensation in the Global Environment

The pay gap between the most affluent executives and the average worker in the United States remains wide. It has been reported that the ratio between CEO and the average worker is 354 to 1 in the United States. By contrast, the ratio is 50 in Venezuela, 22 in Britain, 20 in Canada, and 11 in Japan.⁷⁷ Whereas people in the United States derive great status from high pay, nations in large parts of Europe and Asia shun conspicuous wealth.

Governance of executive pay varies from country to country, but there is a definite increase in shareholder influence on executive pay issues from Europe to North America to Asia Pacific and beyond. This trend will likely continue. Shareholders in Europe have been the leaders of the push. Executives at French firms face binding shareholder votes on certain aspects of their pay packages, including share options and retirement packages. Another proposal in France requires that severance payments be conditional on performance—a practice essentially unheard of in the past. Also, European governments are trying to exert more direct influence over executive pay as well. Legislators in the Netherlands want to limit nonperformance-based compensation by

golden parachute contract

Perquisite that protects executives in the event that another company acquires their firm or the executive is forced to leave the firm for other reasons.

clawback policy

Allows the company to recover compensation if subsequent review indicates that payments were not calculated accurately or performance goals were not met.

imposing an additional tax on salary and severance payments.⁷⁸ Starting in 2003, public companies in the United Kingdom were required to give shareholders an advisory up-or-down vote on executive pay packages. Although the say-on-pay vote is nonbinding, advocates believe that it has increased the discussion between companies and large investors, which resulted in an improved alignment between pay and performance. As an example, share option plans, which were criticized for rewarding short-term share price volatility over long-term value creation, have been largely replaced with performance-contingent stock.⁷⁹

Investors in the Netherlands, Sweden, Norway, and Switzerland can cast a binding vote on executive pay. In addition, Switzerland's law, passed in 2013, prohibits awarding signing bonuses or termination bonuses. Severe fines will be levied on companies that violate the new rules.⁸⁰ Across Europe, companies are making efforts to improve executive pay disclosure. It is quite likely these trends will continue in the wake of the recent recession. The United States has been slow to react to compensation governance, but there is evidence that this may be changing. As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, shareholders get a nonbinding vote on executive pay and generous packages set up for executives who part ways with the company.

Summary

1. **Describe direct financial compensation (core compensation), indirect financial compensation (employee benefits), and nonfinancial compensation.** *Compensation (core compensation)* is the total of all rewards provided employees in return for their services. *Direct financial compensation* consists of the pay that a person receives in the form of wages, salaries, commissions, and bonuses. *Indirect financial compensation (employee benefits)* consists of all financial rewards that are not included in direct financial compensation. *Nonfinancial compensation* consists of the satisfaction that a person receives from the job itself or from the psychological or physical environment in which the person works.
2. **Identify and discuss the components of direct financial compensation.** The components include base pay (hourly wage and salary) and various adjustments to base pay over time. The categories are cost-of-living adjustments, seniority pay, performance-based pay (merit pay and various types of incentive pay practices), and person-focused pay (including competency-based pay).
3. **Review the determinants of direct financial compensation.** HR professionals engage in a variety of activities to establish job structures, compensation policies, and pay structures. Each of these structures is based on a variety of practices. For example, job structures are the outcome of the implementation of both job analysis and job evaluation techniques.
4. **Describe contextual influences on direct financial compensation.** There are many factors that HR professionals

must take into account when building compensation programs. The most prominent considerations are labor unions, the economy, interindustry wage differentials, and a variety of legislation.

5. **Discuss how to use job evaluation to build job structures.** Job evaluation is a process that determines the relative value of one job in relation to another. In the job evaluation ranking method, the raters examine the description of each job being evaluated and arrange the jobs in order according to their value to the company. The *classification* method involves defining a number of classes or grades to describe a group of jobs. In the *factor comparison* method, raters need not keep the entire job in mind as they evaluate; instead, they make decisions on separate aspects or factors of the job. In the *point method*, raters assign numerical values to specific job factors, such as knowledge required, and the sum of these values provides a quantitative assessment of a job's relative worth.
6. **Describe various competitive compensation policies.** Broadly, competitive pay policies refer to pay level and pay mix. *Pay level* choices include whether to lag, match, or lead the market pay rates, on average. *Pay mix* refers to the composition of an employee's direct (core compensation) and indirect (employee benefits) financial compensation. Choices about how to structure pay (for example, base pay, short-term incentives, and employee benefits versus incentives and employee benefits) must be made.
7. **Explain the use of compensation surveys for job pricing and determining market competitive pay structures.**

Compensation surveys enable HR professionals to know the pay level and pay mixes of its competitors. Assigning dollar values to the company's jobs is considered to be *job pricing*.

8. **Discuss compensation for sales representatives.** Designing compensation programs for sales employees involves unique considerations such as the formula for determining incentive payments.
9. **Discuss compensation for contingent workers.** Contingent workers are employed on the expectation of a defined term of employment. Most often, contingent workers receive less

pay and employee benefits than workers who do not have an expectation of a defined term of employment.

10. **Explain executive compensation and the various features of executive compensation packages.** In determining executive compensation, firms typically prefer to relate salary growth for the highest-level managers to overall corporate performance. Executive compensation often has five basic elements: (1) base salary, (2) bonuses and performance-based pay, (3) stock option plans, (4) executive performance-based pay, (5) perquisites, and (6) severance packages.

Key Terms

compensation 225	referral plans 232	job evaluation 240
direct financial compensation (core compensation) 225	gain sharing 233	job evaluation ranking method 240
indirect financial compensation (employee benefits) 225	Scanlon plan 233	classification method 240
nonfinancial compensation 225	profit sharing 234	factor comparison method 241
base pay 227	vesting 234	point method 241
hourly pay (wage) 227	employee stock plans 235	compensation policy 241
salary 227	company stock 235	pay-level compensation policies 241
cost-of-living adjustment (COLA) 227	company stock shares 235	market lead policies 242
real hourly compensation 227	stock options 235	market match policies 242
nominal hourly compensation 227	employee stock option plans (ESOPs) 235	market lag policies 242
seniority 227	stock compensation plans 235	pay mix compensation policies 241
seniority pay 227	deferred compensation 235	pay structures 244
human capital theory 227	job-based pay 235	compensation survey 244
human capital 228	person-focused pay 235	pay grade 244
General Schedule 228	skill-based pay 235	wage curve 245
merit pay 229	competency-based pay 236	pay range 245
merit bonuses 230	labor market 237	broadbanding 246
spot bonuses 231	spillover effect 237	two-tier wage systems 246
incentive pay 231	interindustry wage or compensation differentials 237	salary compression 247
piecework 231	exempt employees 239	perquisites (perks) 249
management incentive plans 231	nonexempt employees 239	say on pay 250
behavioral encouragement plans 231	job structure 240	golden parachute contract 251
		clawback policy 251

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Exercises

- 9-1. What form of incentive compensation might be used for the following jobs to increase productivity?
- machine operator
 - automobile salesperson
 - group of five people cooperating to get the job done
- ★ 9-2. The section on Executive Compensation provided statistics that suggest that some executives today may be paid excessively high salaries. What might be some pros and cons for paying large salaries to top executives?
- 9-3. What form of equity is involved if you hear one of your employees say the following?
- That guy at XYZ Company does the same type work I do but gets \$10,000 more a year.
 - That person in maintenance makes more than I do as the maintenance manager.
 - I joined the firm the same time he did and now he is making \$10,000 more than me for doing the same job.

Questions for Review

- 9-4. Define each of the following terms:
- compensation
 - direct financial compensation
 - indirect financial compensation
 - nonfinancial compensation
- 9-5. What are the contextual influences on direct financial compensation?
- 9-6. Discuss the determinants of direct financial compensation.
- 9-7. Discuss the difference between pay-for-performance and person-focused pay.
- ★ 9-8. What are the differences between pay level and pay mix compensation policies?
- 9-9. How has government legislation affected compensation?
- 9-10. What is the difference between an exempt and a nonexempt employee?
- 9-11. Define *job evaluation*. Give the primary purpose of job evaluation.
- 9-12. Distinguish between the following job evaluation methods:
- ranking
 - classification
 - factor comparison
 - point method
- 9-13. Define *job pricing*. What is the purpose of job pricing?
- 9-14. Define *pay grades*. State the basic procedure for determining pay grades.
- 9-15. Define *pay ranges*. What is the purpose of establishing pay ranges?
- 9-16. Define *broadbanding*. What is the purpose of using broadbanding?
- 9-17. Distinguish between merit pay, bonus, spot bonuses, and piecework.
- 9-18. Discuss the main issues that are associated with compensating contingent workers.
- 9-19. What are some companywide pay plans? Briefly discuss each.
- 9-20. How is the compensation for sales representatives determined?
- ★ 9-21. Describe each of the following:
- say on pay
 - golden parachute contract
 - clawback policies
- 9-22. What are the various types of executive compensation?
- 9-23. How does executive pay in the United States compare to executive compensation in the global environment?

INCIDENT 1 A Motivated Worker

Bob Rosen could hardly wait to get back to work Monday morning. He was excited about his chance of getting a large bonus. Bob is a machine operator with Ram Manufacturing Company, a producer of electric motors in Wichita, Kansas. He operates an armature-winding machine. The machine winds copper wire onto metal cores to make the rotating elements for electric motors.

Ram pays machine operators on a graduated piece-rate basis. Operators are paid a certain amount for each part made, plus a bonus. A worker who produces 10 percent above standard for a certain month receives a 10 percent additional bonus. For 20 percent above standard, the bonus is 20 percent. Bob realized that he had a good chance of earning a 20 percent bonus that month. That would be \$1,787.

Bob had a special use for the extra money. His wife's birthday was just three weeks away. He was hoping to get her a car. He had already saved \$4,000, but the down payment on the car was \$5,500. The bonus would enable him to buy the car.

Bob arrived at work at seven o'clock that morning, although his shift did not begin until eight. He went to his workstation and

checked the supply of blank cores and copper wire. Finding that only one spool of wire was on hand, he asked the forklift truck driver to bring another. Then, he asked the operator who was working the graveyard shift, "Sam, do you mind if I grease the machine while you work?"

"No," Sam said, "that won't bother me a bit."

After greasing the machine, Bob stood and watched Sam work. He thought of ways to simplify the motions involved in loading, winding, and unloading the armatures. As Bob took over the machine after the eight o'clock whistle, he thought, "I hope I can pull this off. I know the car will make Kathy happy. She won't be stuck at home while I'm at work."

Questions

- 9-24. Explain the advantages of a piecework pay system such as that at Ram.
- 9-25. What might be problems associated with the piecework pay system?

INCIDENT 2 The Controversial Job

David Rhine, compensation manager for Farrington Lingerie Company, was generally relaxed and good-natured. Although he was a no-nonsense, competent executive, David was one of the most popular managers in the company. This Friday morning, however, David was not his usual self. As chairperson of the company's job evaluation committee, he had called a late-morning meeting at which several jobs were to be considered for re-evaluation. The jobs had already been rated and assigned to pay grade 3. But the office manager, Ben Butler, was upset that one was not rated higher. To press the issue, Ben had taken his case to two executives who were also members of the job evaluation committee. The two executives (production manager Bill Nelson and general marketing manager Betty Anderson) then requested that the job ratings be reviewed. Bill and Betty supported Ben's side of the dispute, and David was not looking forward to the confrontation that was almost certain to occur.

The controversial job was that of receptionist. Only one receptionist position existed in the company, and Marianne Sanders held it. Marianne had been with the firm 12 years, longer than any of the committee members. She was extremely efficient, and virtually all the executives in the company, including the president, had noticed and commented on her outstanding work. Bill Nelson and Betty Anderson were particularly pleased with Marianne because of the cordial manner in which she greeted and accommodated Farrington's customers

and vendors, who frequently visited the plant. They felt that Marianne projected a positive image of the company.

When the meeting began, David said, "Good morning. I know that you're busy, so let's get the show on the road. We have several jobs to evaluate this morning and I suggest we begin..." Before he could finish his sentence, Bill interrupted, "I suggest we start with Marianne." Betty nodded in agreement. When David regained his composure, he quietly but firmly asserted, "Bill, we are not here today to evaluate Marianne. Her supervisor does that at performance appraisal time. We're meeting to evaluate jobs based on job content. To do this fairly, with regard to other jobs in the company, we must leave personalities out of our evaluation." David then proceeded to pass out copies of the receptionist job description to Bill and Betty, who were obviously very irritated.

Questions

- 9-26. Do you feel that David was justified in insisting that the job, not the person, be evaluated? Discuss.
- 9-27. Do you believe that there is a maximum rate of pay for every job in an organization, regardless of how well the job is being performed? Justify your position.
- 9-28. Assume that Marianne is earning the maximum of the range for her pay grade. In what ways could she obtain a salary increase?

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- 9-29. Why is it important for HR professionals to understand legislation, labor unions, and interindustry wage differentials when establishing compensation programs?
- 9-30. Why might a firm want to be a pay leader as opposed to paying market rate?

Endnotes

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