

Chapter Ten – Self Notes  
**PAY FOR PERFORMANCE: INCENTIVE REWARDS**  
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## SUMMARY

**OUTCOME 1** The success of an incentive pay plan depends on the organizational climate in which it must operate, employee confidence in it, and its suitability to employee and organizational needs. Importantly, employees must view their incentive pay as being equitable and related to their performance. Performance measures should be quantifiable, be easily understood, and bear a demonstrated relationship to organizational performance.

**OUTCOME 2** Piecework plans pay employees a given rate for each unit satisfactorily completed. Employers implement these plans

are given yearly without regard to changes in employee performance. Merit raises are not motivational when they are given because of seniority or favoritism or when merit budgets are inadequate to sufficiently reward employee performance. To be motivational, merit raises must be such that employees see a clear relationship between pay and performance, and the salary increase must be large enough to exceed inflation and higher income taxes.

**OUTCOME 4** Salespeople may be compensated by a straight salary, a combination of salary and commission, salary plus bonus, or a commission only. Paying employees a straight salary allows them to focus on tasks other than sales, such as service and customer goodwill. A straight commission plan causes employees to emphasize sales goals. A combination of salary and commission or bonus provides the advantages of both the straight salary and the straight commission form of payments.

**OUTCOME 5** There are several types of team and group-level incentive plans, including the Scanlon and Improshare gainsharing plans. These plans encourage employees to maximize their performance and cooperation through suggestions offered to improve organizational performance.

when output is easily measured and when the production process is fairly standardized. Bonuses are incentive payments above base wages paid on either an individual or a team basis. A bonus is offered to encourage employees to exert greater effort. Standard hour plans establish a standard time for job completion. An incentive is paid for finishing the job in less than the preestablished time. These plans are popular for jobs with a fixed time for completion.

**OUTCOME 3** Merit raises will not serve to motivate employees when they are seen as entitlements, which occurs when these raises

**OUTCOME 6** Profit-sharing plans pay to employees sums of money based on the organization's profits. Cash payments are made to eligible employees at specified times, normally yearly. The primary purpose of profit sharing is to provide employees with additional income through their participation in organizational achievement. Employee commitment to improved productivity, quality, and customer service will contribute to organizational success and, in turn, to their compensation. Profit-sharing plans may not achieve their stated gains when employee performance is unrelated to organizational success or failure. This may occur because of economic conditions, other competition, or environmental conditions. Profit-sharing plans can have a negative effect on employee morale when plans fail to consistently reward employees.

**OUTCOME 7** With an ESOP, each year the organization contributes stock or cash to buy stock that is then placed in an ESOP trust. The ESOP holds the stock for organizational improvement. Employees, however, may lose their retirement income should the company fail or stock prices fall.

## **OUTCOME ONE: REQUIREMENTS FOR A SUCCESSFUL INCENTIVE PLAN**

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- A major element of strategic compensation management is the use of incentive plans, also called variable pay programs, for employees throughout the organization.
- **Variable Pay:** Tying pay to some measure of individual, group, or organizational performance.
- Incentive pay programs establish a performance “threshold” that an employee or group of employees must reach to qualify for incentive payments.
- Incentive plans emphasize a shared focus on organizational objectives by broadening the opportunities for incentives to employees throughout the organization.
- **2 reasons to implement incentive plans:**
  1. **Encourages** employees to put out more effort to complete their job tasks.
  2. **Attract and retain** top-performing employees.
- **3 reasons why incentive plans fail:**
  1. Fails to satisfy employee expectations for pay gains.
  2. Management may have failed to give adequate attention to the design and implementation of the plan, leaving employees confused about how incentive payments are calculated.
  3. Employees may have little ability to affect performance standards.
- **2 factors the degree of success depends on (not limited to):**
  1. Identifying important organizational metrics by which to measure employee performance.
  2. A customized incentive plan that effectively measures employee output and rewards exceptional employee performance.
- Encouraging employees to participate in developing and administering the plan is likely to increase their willingness to accept it.
- Employees must be able to see a clear connection between the incentive payments they receive and their job performance.
- Management should never allow incentive payments to be seen as an entitlement.
  - These payments should be viewed as a reward that must be earned through effort.
- The best managed incentive pay programs are clearly and continuously communicated to employees.
- Commitment by employees to meet the standards is essential for incentive plans to succeed.
- Measurement is key to the success of incentive plans because it communicates the importance of established organizational goals.
  - Measures that are quantitative, simple, and structured to show a clear relationship to improved performance are best.
  - It is necessary to evaluate the extent to which the employees involved can actually influence the measurement.

**FIGURE 10.2**

**ADVANTAGES OF INCENTIVE PAY PROGRAMS**

- Incentives focus employee efforts on specific performance targets. They provide real motivation that produces important employee and organizational gains.
- Incentive payouts are variable costs linked to the achievement of results. Base salaries are fixed costs largely unrelated to output.
- Incentive compensation is directly related to operating performance. If performance objectives (quantity and/or quality) are met, incentives are paid. If objectives are not achieved, incentives are withheld.
- Incentives foster teamwork and unit cohesiveness when payments to individuals are based on team results.
- Incentives are a way to distribute success among those responsible for producing that success.
- Incentives are a means to reward or attract top performers when salary budgets are low.

**FIGURE 10.1**

**TYPES OF INCENTIVE PLANS**

Individual	Group	Enterprise/Organization
Piecework	Team compensation	Profit sharing
Standard hour plan	Scanlon Plan	Stock options
Bonuses	Improshare	Employee stock ownership plans (ESOPs)
Merit pay		
Lump-sum merit pay		
Incentive awards		
Sales incentives		
Incentives for professional employees		
Executive incentives		

- Awards are used to recognize productivity gains, special contributions or achievements, and service to the organization.
- Recognition is a conduit that shows employees that the company appreciates their efforts, their unique gifts, and their contributions.

**OUTCOME TWO: INDIVIDUAL INCENTIVE PLANS**

- The design of individual incentive plans should be flexible.
- **4 types of individual incentive plans:**
  1. **Piecework**
    - **Straight Piecework:** An incentive plan under which employees receive a certain rate for each unit produced.
    - **Differential Piece Rate:** A compensation rate under which employees whose production exceeds the standard amount of output receive a higher rate for all of their work than the rate paid for those who do not exceed the standard amount.

- The piecework system is more likely to succeed when units of output can be measured readily, the quality of the product is less critical, the job is fairly standardized, and a constant flow of work can be maintained.
- Piecework can work against an organizational culture promoting workforce cooperation, creativity, or problem solving because each of these goals can infringe on an employee's time and productivity and therefore, total incentive earned.
- Piecework may be inappropriate in the following situations:
  - When quality is more important than quantity.
  - When technology changes are frequent.
  - When productivity standards on which piecework must be based are difficult to develop.
- Computing the Piece Rate – Ex. The standard time for the producing one unit of work in a job paying \$12.75 per hour was set at 12 minutes. The piece rate would be \$2.55 per unit, computed as follows:

<p style="text-align: center;">60 minutes per hour          12 standard time per hour = 5 units per hour          \$12.75 hourly rate = \$2.55 per unit          5 units per hour</p>
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2. **Standard Hour Plan**

- An incentive plan that sets rates based on the completion of a job in a predetermined standard time.
- If employees finish the work in less than the expected time, their pay is still based on the standard time for the job multiplied by their hourly rate.

3. **Bonuses**

- **Bonus:** An incentive payment that is supplemental to the base wage.
  - It is frequently given at the end of the year and does not become part of base pay.
  - Bonuses have the advantage of providing employees with more pay for exerting greater effort, while at the same time the employees still have the security of a basic wage.
- **Spot Bonus:** An unplanned bonus given for employee effort unrelated to an established performance measure.
  - Ex. A customer service representative might receive a spot bonus for working long hours to fill a new customer's large order.

4. **Merit Pay** – refer to Outcome Three

### **OUTCOME THREE: MERIT PAY**

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- A merit pay program (merit raise) links an increase in base pay to how successfully an employee performs his or her job.
- The merit increase is normally given on the basis of an employee having achieved some objective performance standard.
- Merit raises can serve to motivate if employees perceive the raise to be related to the performance required to earn it.
- A strategic compensation policy must differentiate between outstanding and good or average performance.
- **Merit Guidelines:** Guidelines for awarding merit raises that are tied to performance objectives.
  - Organizations using a true merit pay plan often base the percentage pay raise on merit guidelines tied to performance appraisals.
  - When setting merit percentage guidelines, organizations should consider individual performance along with such factors as training, experience, and current earnings.
- **Lump-Sum Merit Pay:** Program under which employees receive a year-end merit payment, which is not added to their base pay.
  - Provides a clear link between pay and performance.
  - For employers, lump-sum payments essentially freeze base salaries, thereby maintaining annual salary and benefit costs, because the level of benefits is normally calculated from salary levels.
  - Organizations should adjust base salaries upward after a certain period of time as these adjustments keep pace with the rising cost of living and increases in the general market wage.

### **OUTCOME FOUR: SALES INCENTIVES**

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- **4 sales incentives plans:**
  1. **Straight Salary Plan:** A compensation plan that permits salespeople to be paid for performing various duties that are not reflected immediately in their sales volume.
  2. **Straight Commission Plan:** A compensation plan based on a percentage of sales.
  3. **Combined Salary and Commission Plan:** A compensation plan that includes a straight salary and a commission.
  4. **Salary Plus Bonus Plan:** A compensation plan that pays a salary plus a bonus achieved by reaching targeted sales goals.

### **OUTCOME FIVE: GROUP INCENTIVE PLANS**

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- Group incentive plans encourage a cooperative spirit among all employees and reward them for their total contribution to the organization.

- The emphasis on cost reduction and total quality management has led many organizations to implement a variety of group incentive plans (ex. Perfectly Paperless at belairdirect).
- **2 types of group incentive plans:**
  1. **Team Incentive Plan:** A compensation plan in which all team members receive an incentive bonus payment when production or service standards are met or exceeded.
  2. **Gainsharing Incentive Plan:** Programs under which both employees and the organization share financial gains according to a predetermined formula that reflects improved productivity and profitability.

#### **OUTCOME SIX: ENTERPRISE INCENTIVE PLANS**

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- Enterprise incentive plans reward employees on the basis of the success of the organization over an extended time period – normally one year, but the period can be longer.
- Seeks to create a “culture of ownership” by fostering a philosophy of cooperation and teamwork among all organizational members.
- **3 types of enterprise incentive plans:**
  1. **Profit Sharing Plans**
    - **Profit Sharing:** Any procedure by which an employer pays, or makes available to all regular employees, in addition to base pay, special current or deferred sums based on the profits of the enterprise.
    - Intended to give employees the opportunity to increase their earnings by contributing to the growth of their organization’s profits.
  2. **Employee Stock Options Plans**
    - Stock option programs are sometimes implemented as part of an employee benefit plan or as part of a corporate culture linking employee effort to stock performance.
    - By allowing employees to purchase stock, the organization hopes they will increase their productivity, assuming a partnership role in the organization, and thus cause the stock price to rise.
    - When stock prices rise, employee stock plans can be financially rewarding to employees.
  3. **Employee Stock Ownership Plans (ESOPs)** – Refer to Outcome Seven

#### **OUTCOME SEVEN: EMPLOYEE STOCK OWNERSHIP PLANS (ESOPS)**

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- **Employee Stock Ownership Plans (ESOPs):** Stock plans in which an organization contributes shares of its stock to an established trust for the purpose of stock purchases by employees.
  - Stock plans allow employees to acquire shares in a firm that employs them.
- **3 types of employee stock plans:**

1. **Employee Stock Bonus Plan** – Simplest; an employer provides company shares to employees at no cost to the employee by just granting them or by linking the granting to some kind of performance pay plan.
  2. **Employee Stock Purchase Plan** – Allows employers to purchase shares but not pay full market price for these shares.
  3. **Employee Stock Option Plan** – Employees are given the option to purchase shares in the company at some future date, at a set price, which they would exercise if the market price rises to exceed this price.
- **3 advantages of ESOPs:**
    1. Increase employees' pride of ownership in the organization – provides incentive to increase productivity and help the organization prosper and grow.
    2. Does not require companies to pay out in cash, so firms can reward advantage of not requiring companies.
    3. For employees, the advantages include a form of saving for retirement.
  - **3 problems with ESOPs:**
    1. Company may not be able to pay back the shares of employees when they retire during times where the company suffers financial difficulties and the value of the companies' shares fall.
    2. Employees may become demotivated and frustrated if the share price falls, even though they have worked productivity.