# CHAPTER 9
# COMPENSATION

## CHAPTER DESCRIPTION

We began this chapter by considering the question of whether top executives are paid too much. Next, we describe the various forms of compensation and explain the concept of equity in financial compensation. Then we discuss determinants of individual financial compensation and describe how the organization influences financial compensation. This is followed by discussions of how both the labor market and the job are factors in determining financial compensation. Then we explore how jobs are priced. Next, factors related to the employee that are essential in determining financial compensation are described. Finally, we consider compensation for special groups, how executive compensation is determined, and the types of executive compensation.

## KEY TERMS

**Compensation:** The total of all rewards provided employees in return for their labor.
**Direct financial compensation:** Pay that a person receives in the form of wages, salary, bonuses, and commissions.
**Indirect financial compensation:** All financial rewards that are not included in direct compensation.
**Nonfinancial compensation:** The satisfaction that a person receives from the job itself or from the psychological and/or physical environment in which the job is performed.
**Equity:** The perception by workers that they are being treated fairly.
**External equity:** Payment of employees at rates comparable to those paid for similar jobs elsewhere.
**Internal equity:** Payment of employees according to the relative values of their jobs within an organization.
**Employee equity:** A condition that exists when individuals performing similar jobs for the same firm are paid according to factors unique to the employee, such as performance level or seniority.
**Team equity:** Payment of more productive teams in an organization at a higher rate than less productive teams.
**Compensation policy:** Polices that provide general guidelines for making compensation decisions.
**Pay leaders:** Those organizations that pay higher wages and salaries than competing firms.
**Market (going) rate:** The average pay that most employers provide for the same job in a particular area or industry.
**Pay followers:** Companies that choose to pay below the going rate because of a poor financial condition or a belief that they simply do not require highly capable employees.
**Labor market:** The geographic area from which employees are recruited for a particular job.
**Compensation survey:** A means of obtaining data regarding what other firms are paying for specific jobs or job classes within a given labor market.
**Benchmark job:** A well-known job in the company and industry and one performed by a large number of employees.
**Cost-of-living allowance (COLA):** An escalator clause in a labor agreement that automatically increases wages as the U.S. Bureau of Labor Statistics' cost-of-living index rises.
**Exempt employees:** Those categorized as executive, administrative, or professional employees and outside salespersons.
**Job evaluation:** That part of a compensation system in which a company determines the relative value of one job in relation to another.
**Job evaluation ranking method:** A 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:** A job evaluation method in which classes or grades are defined to describe a group of jobs.
**Factor comparison method:** A job evaluation method in which raters need not keep an entire job in mind as they evaluate it; instead, they make decisions based on separate aspects or factors of the job.
**Point method:** An approach to job evaluation in which numerical values are assigned to specific job components, and the sum of these values provides a quantitative assessment of a job's relative worth.
**Hay guide chart-profile method (Hay Plan):** A highly refined version of the point method of job evaluation that uses the factors of know-how, problem solving, accountability, and additional compensable elements.
**Job pricing:** Placing a dollar value on the worth of a job.

**Pay grade:** The grouping of similar jobs to simplify the job-pricing process.
**Wage curve:** The fitting of plotted points on a curve to create a smooth progression between pay grades (also known as the *pay curve)*.
**Pay range:** A minimum and maximum pay rate for a job, with enough variance between the two to allow for a significant pay difference.
**Broadbanding:** A compensation technique that collapses many pay grades (salary grades) into a few wide bands in order to improve organizational effectiveness.
**Merit pay:** Pay increase given to employees based on their level of performance as indicated in the appraisal. The increase is added to the employee's base pay.
**Bonus (lump sum payment):** A one-time award that is not added to employees' base pay.
**Piecework:** An incentive pay plans in which employees are paid for each unit produced.
**Skill-based pay:** A system that compensates employees on the basis of job-related skills and the knowledge they possess.
**Competency-based pay:** A compensation plan that rewards employees for their demonstrated expertise.
**Seniority:** The length of time that an employee has worked in various capacities with the firm.
**Profit sharing:** A compensation plan that results in the distribution of a predetermined percentage of the firm's profits to employees.
**Gainsharing:** Plans designed to bind employees to the firm's productivity and provide an incentive payment based on improved company performance.
**Scanlon plan:** A gainsharing plan that provides a financial reward to employees for savings in labor costs that result from their suggestions.
**Stock option plan:** An incentive plan in which managers can buy a specified amount of stock in their company in the future at or below the current market price.
**Indexed stock option plan:** A stock option plan that holds executives to a higher standard and requires that increased stock compensation be tied to outperforming peer groups or a market index.
**Perquisites (perks):** Special benefits provided by a firm to key executives to give them something extra.
**Golden parachute contract:** A perquisite provided for the purpose of protecting executives in the event their firm or they are forced to leave the firm for other reasons.

## LECTURE OUTLINE

### COMPENSATION: AN OVERVIEW

**COMPENSATION**—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, bonuses, and commissions.

**INDIRECT FINANCIAL COMPENSATION**—All financial rewards that are not included in direct compensation.

**NONFINANCIAL COMPENSATION**—Consists of the satisfaction that a person receives from the job itself or from the psychological and/or physical environment in which the person works.

### EQUITY IN FINANCIAL COMPENSATION

Organizations must strive for compensation equity.

**EQUITY**—Compensation must be fair to all parties concerned and be perceived as fair.

**EXTERNAL EQUITY—**Exists when a firm's employees are paid comparably to workers who perform similar jobs in other firms.

**INTERNAL EQUITY**—Exists when employees are paid according to the relative value of their jobs within an organization.

**EMPLOYEE EQUITY**—Exists when individuals performing similar jobs for the same firm are paid according to factors unique to the employee, such as performance level or seniority.

**TEAM EQUITY**—Achieved when more productive teams are rewarded more than less productive teams.

## DETERMINANTS OF INDIVIDUAL FINANCIAL COMPENSATION

The organization, the labor market, the job, and the employee all have an impact on job pricing and the ultimate determination of an individual's financial compensation.

## THE ORGANIZATION AS A DETERMINANT OF FINANCIAL COMPENSATION

**COMPENSATION POLICIES**—An organization often establishes—formally or informally—compensation policies that determine whether it will be a pay leader or a pay follower, or strive for an average position in the labor market.

**Pay leaders**: Those organizations that pay higher wages and salaries than competing firms.

**Market rate, or going rate**: The average pay that most employers provide for the same job in a particular area or industry.

**Pay followers**: Companies that choose to pay below the market rate because of poor financial condition or a belief that they simply do not require highly capable employees.

ORGANIZATIONAL LEVEL—Upper management often makes these decisions to ensure consistency.

**ORGANIZATIONAL POLITICS**—Political considerations may also enter into the equation.

**ABILITY TO PAY**—An organization's assessment of its ability to pay is also an important factor in determining pay levels.

## THE LABOR MARKET AS A DETERMINANT OF FINANCIAL COMPENSATION

Potential employees located within the geographical area from which employees are recruited comprise the *labor market*.

**COMPENSATION SURVEYS**—Large organizations routinely conduct compensation surveys to determine prevailing pay rates within labor markets.

**EXPEDIENCY**—The competition for highly skilled employees may be so intense in some labor markets that managers occasionally are left to their own devices.

**COST OF LIVING**—A pay increase must be roughly the equivalent to the cost of living increase if a person is to maintain a previous level of real wages.

**LABOR UNIONS**—When a union uses comparable pay as a standard for making compensation demands, the employer must obtain accurate labor market data.

**SOCIETY**—Compensation paid to employees often affects a firm's pricing of its goods and/or services. Consumers may also be interested in compensation decisions.

**ECONOMY**—The economy's health exerts a major impact on pay decisions.

**LEGISLATION**—The amount of compensation a person receives can also be affected by certain federal and state legislation.

**Davis-Bacon Act of 1931**: This act requires federal construction contractors with projects valued in excess of $2,000 to pay at least the prevailing wages in the area.

**Walsh-Healy Act of 1936**: The act requires companies with federal supply contracts exceeding $10,000 to pay prevailing wages. The act also requires one and a half times the regular pay rate for hours over 8 per day or 40 per week.

**Fair Labor Standards Act of 1938, as Amended**: Establishes a minimum wage, requires overtime pay, record keeping, and provides standards for child labor.

**Equal Pay Act of 1963**: The act prohibits discrimination in pay on the basis of gender.

**THE JOB AS A DETERMINANT OF FINANCIAL COMPENSATION**
Techniques used to determine a job's relative worth include job analysis, job descriptions, and job evaluation.

**JOB ANALYSIS AND JOB DESCRIPTIONS**—Before an organization can determine the relative difficulty or value of its jobs, it must first define their content, which it normally does by analyzing jobs.

**JOB EVALUATION**—That part of a compensation system in which a firm determines the relative value of one job compared with that of another.

**Ranking method**: Raters examine the description of each job being evaluated and arrange the jobs in order according to their value to the company.

**Classification method**: A job evaluation method by which a number of classes or grades are defined to describe a group of jobs.

**Factor comparison method**: A basic underlying assumption is that there are five universal job factors: (1) Mental requirements; (2) Skills; (3) Physical requirements; (4) Responsibilities; and (5) Working conditions.

**Point method**: Raters assign numerical values to specific job components, and the sum of these values provides a quantitative assessment of a job's relative worth.

**Hay guide chart-profile method**: A highly refined version of the point method that uses the factors of know-how, problem solving, accountability, and, where appropriate, working conditions.

**JOB PRICING**
Placing a dollar value on the worth of a job.

**PAY GRADES**—The grouping of similar jobs together to simplify the job pricing process.

**WAGE CURVE**—The fitting of plotted points in order to create a smooth progression between pay grades.

**PAY RANGES**—Includes a minimum and maximum pay rate with enough variance between the two to allow some significant pay difference.

**BROADBANDING**—A technique that collapses many pay grades (salary grades) into a few wide bands in order to improve organizational effectiveness.

**SINGLE RATE SYSTEM**—When single rates are used, everyone in the same job receives the same base pay, regardless of seniority or productivity.

**ADJUSTING PAY RATES**—When pay ranges have been determined and jobs assigned to pay grades, it may become obvious that some jobs are overpaid and others underpaid.

**THE EMPLOYEE AS A DETERMINANT OF FINANCIAL COMPENSATION**
Factors related to the employee are essential in determining pay and employee equity.

**PERFORMANCE BASED PAY**—A compensation feature generally controllable by employees is their job performance.

**Merit pay**: A pay increase given to employees based on their level of performance as indicated in the appraisal.

**Variable pay (Bonus)**: The most common type of variable pay for performance and is a one time award which is not added to employees' base pay.

**Piecework**: A plan where employees are paid for each unit they produce

**SKILL-BASED PAY**—A system that compensates employees on the basis of job-related skills and knowledge they possess, not for their job titles.

**Benefits for Individuals and Organizations**: When employees obtain additional job-relevant skills, both individuals and the departments they serve, benefit.

**Appropriate Conditions**: Typically, skill pay is most appropriate in settings where the work tends to be routine and less varied, such as skills of assembly or responding to customer service questions.

**Management Challenges**: The firm must provide adequate training opportunities or else the system can become a demotivator.

**COMPETENCY-BASED PAY**—A compensation plan that rewards employees for their demonstrated expertise.

**SENIORITY**—The length of time an employee has been associated with the company, division, department, or job.

**EXPERIENCE**—Regardless of the nature of the task, very few factors have a more significant impact on performance than experience.

**MEMBERSHIP IN THE ORGANIZATION**—Some components of individual financial compensation are given to employees without regard to the particular job they perform or their level of productivity.

**POTENTIAL**—Organizations do pay some individuals based on their potential.

**POLITICAL INFLUENCE**—Political influence is a factor that obviously should not be used as a determinant of financial compensation. However, to deny that it exists would be unrealistic.

**LUCK**—The expression has often been stated, "It certainly helps to be in the right place at the right time."

## COMPENSATION FOR SPECIAL GROUPS

The groups include teams, the entire organization, professionals, sales employees and contingency workers.

**TEAM-BASED PAY**—If a team is to function effectively, firms should provide a reward based on the overall team performance as well.

**COMPANY-WIDE PLANS**—Organizations normally base company-wide plans on the firm's productivity, cost savings, or profitability.

**Profit sharing**: A plan that results in the distribution of a predetermined percentage of the firm's profits to employees.

**Gainsharing**: A plan designed to bind employees to the firm's productivity and provides an incentive payment based on improved company performance.

**Scanlon plan**: A plan that provides a financial reward to employees for savings in labor costs that result from their suggestions.

**COMPENSATION FOR PROFESSIONALS—**People in professional jobs are initially compensated primarily for the knowledge they bring to the organization.

**COMPENSATION FOR SALES EMPLOYEES**—Designing compensation programs for sales employees involves unique considerations.

**COMPENSATION FOR CONTINGENCY WORKERS**—In most cases, contingents earn less pay and are far less likely to receive health or retirement benefits than their permanent counterparts.

**EXECUTIVE COMPENSATION**

A critical factor in attracting and retaining the best managers is a company's program for compensating executives.

**DETERMINING EXECUTIVE COMPENSATION**—In determining executive compensation, firms typically prefer to relate salary growth for the highest-level managers to overall corporate performance.

**TYPES OF EXECUTIVE COMPENSATION**—The way an executive compensation package is designed is partially dependent on the ever-changing tax legislation.

**Base salary**: It is a factor in determining standard of living. Salary also provides the basis for other forms of compensation.

**Short-term incentives, or bonuses**: Payment of bonuses reflects a managerial belief in their incentive value.

**Long-term incentives and capital appreciation**: The stock option is a long-term incentive designed to integrate further the interests of management with those of the organization.

**Stock Option Plans**: There are various types of plans, but the typical stock option plan gives the manager the option to buy a specified amount of stock in the future at or below the current market price.

**Indexed Stock Option Plans:** An indexed stock option plan holds executives to a higher standard and requires that increased stock compensation relate to outperforming peer groups or a market index.

**Executive Benefits (Perquisites or Perks)**: Executive benefits are generally more generous than those received by other employees because the benefits are tied to their higher salaries.
**Golden Parachutes**: A golden parachute contract is a 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.

**HR'S ROLE IN EXECUTIVE COMPENSATION—**HR executives who know their company's business must play a key role in this endeavor and assure reasonable and ethical behavior.