UNIT 10 REWARD AND COMPENSATION

Objectives

The objectives of this unit are:

- to familiarise you with general nature of compensation plan;
- to familiarise you with long term and short term compensation plan;
- to explain the process of compensation setting first at corporate level and then at business unit level; and
- to familiarise you with research findings on organizational incentives.

Structure

10.1 INTRODUCTION

An `Incentive' or `reward' can be anything that attracts a employee's attention and stimulates him to work. In the words of Burack and Smith, An incentive scheme is a plan or program to motivate individual or group performance. Incentive program is most frequently built on monetary rewards (incentive pay or monetary bonus), but may also include a variety of non-monetary rewards or prizes."

On the other hand, French says, the term "incentive system has a limited meaning that excludes many kinds of inducements offered to people to perform work, or to work up to or beyond acceptable standards. It does not include: (i) wage and salary payments and merit pay (ii) over-time payments, pay for holiday work or differential according to shifts, i.e. all payments which could be considered incentives to perform work at undesirable times (iii) premium pay for performing dangerous tasks. It is related with wage payment plans that tie wages directly or indirectly to standards or productivity or to the profitability of the organization or to both criteria.

The use of incentives assumes that people's actions are related to their skills and ability to achieve important longer-run goals. Even though many organizations, by choice, or tradition or contract, allocate rewards on non-performance criteria rewards should be regarded as a "pay off" for performance.

An incentive plan has the following important features:

1) An incentive plan may consist of both `monetary' and 'non-monetary' elements. Mixed elements can provide the diversity needed to match the needs of individual' employees.

2) The timing, accuracy and frequency of incentives are the very basis of a successful incentive plans.

3) The plan required that it should be properly communicated to the employees to encourage individual performance, provide feedback and encourage redirection.

Compensation

Enterprise employees are happier with good compensation plans, which are well administered. They will have a salutary effect on their entire work, co-operation and loyalty is higher, amount of output is up, and quality is better. In the absence of such plans compensation is determined subjectively on the basis of haphazard and arbitrary decisions. This creates several inequalities which are among the most dangerous sources of friction and low morale in an enterprise.

Although there can be both monetary and non-monetary forms of compensation prevalent in an enterprise, yet it is the former which is most basic element by which individuals are attracted to an organization, persuaded to remain, and induced to engage in behaviour beneficial to the organisation.

There are three requisites of a sound compensation structure:

1) It should be internally equitable,

2) It should be externally competitive, and

3) It should pay individuals on the basis of their performance.

10.2 OVERRIDING OBJECTIVES

We visualize four objective of reward and compensation system including recruitment of people in the company, control of payroll costs, satisfaction of individuals and reduction of voluntary separations, grievance and conflicts regarding pay and motivation of human resources to higher productivity.

First, compensation seeks to accomplish a labour market function of allocating human resources among different enterprises in terms of perceived attractiveness of wages and salary. It is an effective measures to attract human resources for recruitment purposes in a competitive labour market.

Second, carefully designed compensation system facilitate control of wages and salaries and labour costs. Management may take care to control the distribution of rates within a predetermined rate range and exert control upon the frequency and volume of pay increments. Accordingly, each department may be allowed to pay only within a prescribed rate range embodied in a tightly controlled table of organization.

Third, the financial compensation system seeks to maintain satisfaction of human resources reducing voluntary separations and complaints and grievances stemming from inadequate or inequitable wages, as perceived by *the* employees. An effective reward and compensation system is likely to give the feeling that the remuneration is fair and that no favoritism has been practiced in its payment. Indeed, in situations where the remuneration is perceived as adequate and equitable, it is likely to check employee dissatisfaction.

Fourth, the financial compensation system purports to induce and reward improved performance and forms an effective motivator. It is usually held that increase in pay should be determined on the basis of productivity and that those who produce more should be paid more.

It has been observed that although the former three goals are accomplished markedly, the latter motivational goals are largely ignored in organizational settings. It would be a mistaken view to hold that money is not a motivator. Indeed, motivation stems from both financial and non-financial incentives, although one is dominating the other at times. Money in addition to satisfying material necessities of life has a symbolic value. It symbolizes security, prestige, recognition and forms a measure of success and achievement. Thus, it is an effective measure for the satisfaction of higher order needs. However, rigid design and operation of reward and compensation systems, although accomplish the control and equitable functions, discourages the motivational function of financial compensation. Frequently, the contributions of individuals cannot be determined in team activities or process-paced work and the performance appraisal is highly subjective. This further hampers the motivational impact of reward and compensation to accomplish higher productivity of human resources.

Activity 1

List the main objectives of a reward and compensation plan.

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10.3 CHARACTERISTICS OF INCENTIVE COMPENSATION PLANS

A manager's total compensation consists of three components (1) A predetermined fixed salary with regular increments over a period of time (2) benefits which include health cover for self and family, pension schemes and other perquisites of various types (3) incentive compensation. These three components are inter related but the third component is specifically related to management control system.

In most countries corporate and securities law mandates that incentive compensation plans and revision of existing plans be approved by the shareholder whereas no such approval is required for salaries and perquisites. Before approval by the shareholder the plans have to be approved by the Board of Directors. The compensation committee of the board of directors is deeply involved in the formulation of these plans.

The incentive compensation can be divided into (1) short term incentive plans, which are based on the performance of the current year (2) long term performance plans which relate compensation to long term results usually ranging from three to five years. Before discussing further about these plans let us have a look at various forms of rewards and punishments as practised by different companies.

Table 10.1: Examples of Positive and Negative Rewards

Positive Rewards	**Negative Rewards**
Autonomy power	Interference in job
Member of decision	Loss of job
Increments making teams Bonuses	Zero salary increase
Bonuses	Assignment to unimportant tasks
Stock options	Chastisement
Restricted stocks	No promotion
Public praise and recognition	Demotion
Promotion	Public humiliation
Titles	Transfer
Job assignments	
Office assignments	
Exclusive parking space	
Club membership	
Job security	
Company paid vacation trips	
Participation in conferences, seminars	
Executive development program etc	

Activity 2

Try to find out the various forms of rewards and punishments as practised in your organization.

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10.3.1 Short Term Incentive Plans

These systems may be broadly classified into three categories:

a) Systems under which the rate of extra incentive is in proportion to the extra output;

b) System under which the extra incentive is proportionately at a lower rate than the increase in output; and

c) System under which the rate of incentive is proportionately higher than the rate of increase in output

Every employer wants his workmen to do the maximum work they are capable of doing. On the other hand, there is a feeling among the workers that an increase **in** effort benefits only the employer even when they are employed on a piece-rate basis. The result is that they never produce to their full capacity, and, in most cases, put in the minimum necessary work. This feeling on the part of workers may be removed either through fear or through expectation of gain. It has been found that fear can never produce the desired effect; but a hope of earning a bonus does induce them to work harder and produce more. Incentive plans are, therefore, known as premium plans because they offer a premium for outstanding performance.

All bonus of premium plans relate to two factors: one. they set a standard time for the completion of a definite output or piece of work for a fixed wage; two, the fixing of a rate of percentage by which bonus would be earned by a worker over and above his set wage, if the standard time is saved or the standard output is exceeded.

Merits: The chief advantages of a short-term incentive plan are:

l) When well-designed and properly applied, payment by results may generally be relied upon to yield increased output, lower the cost of production, and bring a higher income to the workers.

2) A works study associated with payment by results is a direct stimulus to workers to improve the organization of work and to eliminate lost time and other waste.

3) Labour and total costs per unit of output can be estimated more accurately in advance.

4) Less direct supervision is needed to keep output up to a reasonable level.

5) The conflicting interests of employers and employees are unified. increased efficiency and smooth working can therefore be promoted and sustained.

Demerits: The plan suffers from the following defects:

1) Quality tends to deteriorate unless there is a stricter system of checking and inspection;

2) Payment by results may lead to opposition or restriction on output when new machines and methods are proposed or introduced. This is because of the fear that the job may be redesigned and earnings reduced.

3) When paid by result, workers tend to regard their highest earnings as norms, and, therefore, press for a considerable higher minimum wage.

4) The amount and cost of clerical work increases, if done manually.

5) There is a danger of disregarding safety regulations and thereby increasing the rate of accidents.

Some Important Short-Term Incentive Plans

1) Halsey Premium Plan.

2) Halsey Weir Premium Plan.

3) Rowan Premium Plan

4) The 100 per cent Premium Plan

5) The Bedeaux Point Plan

6) Taylor's Differential Piece Rate Plan

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7) Merric's Multiple Piece Rate Plan.

8) Gnatt Task Plan**.**

9) Emerson Efficiency Plan.

10) Co-partnership System.

11) Accelerating Premium Systems.

12) Profit Sharing.

Activity 3

List the merits and demerits of short term incentive plans.

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After discussing the general characteristic and merits and demerits of short term incentive plan, now let us discuss some of the specific short term incentive plans.

1) **The total bonus plan :** Under this plan the shareholders vote on the formula to be used to calculate the total amount of bonus that can be paid to qualified group of workers in a given year which is called the **bonus pool.** There are several methods of calculating the bonus pool some of which are described below:

   a) Let the bonus pool be equivalent to a set percentage of profits. For example if profits of Rs. 20 crore represent an average profitable year and if bonus pool of Rs. I crore is required to make executive compensation competitive, the bonus formula could be set at 5% of the net income to pay bonuses.

      The main drawback of this method is that the bonuses will be payable even at lower levels of profitability and this method also fails to reflect additional investment due to which there may be increased profits, therefore, many companies use formulas that pay bonuses only after a specified return has been earned on capital. There are many ways to accomplish this. One method is to base the bonus on earning per share, the bonus to be calculated on the earning per share exceeding a predetermined level of earning per share. However, this method fails to take into account the reinvestment of retained' earnings which increases the investment base/capital of the company. This drawback can be overcome by increasing the minimum earning per share by a percentage of the annual increase in retained earnings.

   b) Another method of relating profits to the capital employed is to take into consideration share holders equity plus long terms liabilities. The bonus is equal to a percent of the profits before taxes and interest on long terms debt minus a capital charge on the total shareholder equity plus long term debt, the underlying reasoning being that managerial performance should be based on employing corporate's net asset profitably and since the capital structure is not determined by the operating managers this proportion should not influence the judgement about operating performance. A variant of the above method is to define the capital as equal to shareholder equity.

The main drawback of the above two methods is that a loss year erodes/ reduces shareholders equity resulting in increased bonus in profitable years. This drawback may induce managers to go for big losses in anticipation of increased bonus in the coming years.

c) Another method to base bonuses is on the basis of increase in the profitability over the preceding year, the main drawback of this method; is that even a normal performance after a bad year would be rewarded and a good performance after a good year would be ignored. This drawback can be partially tackled with the use of the moving averages of the profits for a number of years.

d) Another method to base bonus is on the basis of relative performance of the company with reference to industry or its nearest competitor. However, very few companies have identical product mix or employ uniform accounting practises therefore, comparison may be difficult. This method could also result in higher bonus for mediocre performance if the industry had a bad year.

While calculating bonus based on profit and capital components certain adjustments need to be made in the reported amount of net income and reported amount of share holder's equity. Extraordinary gains or losses are to be excluded from net profit.

2) **Carryovers:** Under the total bonus pool method, the total bonus arrived on the basis of predefined formula is available for distribution in that particular year. During recent years we have witnessed volatile swings in the business cycles resulting in volatile swings in earnings of the companies, this gives rise to the problem of managing expectations and motivation. During a good year high bonus will give rise to the expectation of similar bonus for the future period, which is unrealistic. Similarly during bad year low bonus would result in lack of motivation.

This shortcoming can be overcome by using the method of carryovers under which the total amount of bonus determined is not available for distribution but only a part as decided by the committee of the board of directors is available for distribution. The rest of the unpaid bonus is transferred to the bonus pool which is available for distribution in future period. This method has two advantages

- it offers more flexibility since amount of bonus is not determined by a formula and the board of directors can exercise their discretion
- It reduces the magnitude of swings which accompany when bonus payments are strictly as per the formula. The main disadvantage of this method is that the bonus are not related to current performance which may lead to slackness in current efforts.

3) **Deferred Compensation:** Another variation of carry over method is deferred compensation. Under this method the bonus is calculated every year, but payment to recipients is spread over a number of years usually ranging from three to five years. Under this method managers receive only one fifth of their bonus in the year which it was earned and the remaining four fifth is paid out equally in the next four years, thus a manager working under this plan for five years, the bonus would consist of on-fifth of the bonus of the current year plus one-fifth of each of bonuses pertaining to four previous years. The main advantage of this method is:

- managers can estimate, with reasonable accuracy, their cash income for the coming year
- deferred payments average the effect of cyclical swings thereby resulting

in uniform cash flow;

- managers will receive bonus for a number of years even after retirement, Which results in two fold advantage
  - i) augmentation of retirement income
  - ii) tax advantage due to the fact that retirement income is taxable at lower rates.
- The deferred time frame encourages long term thinking on the part of managers.

  The main disadvantage of this method is since the donus is not adequqtely related to the currently performance, therefore, it's impact as an incentive for current performance is greatly dampened.

10.3.2 Long Term Incentive Plans

Long term incentive awards are based on performance measured over a period greater than one year. A basic premise of many long term incentive plans is that the share price of the company reflects the company's long term performance. In other type of long term incentive plan the performance is measured in terms of accounting variables, the most commonly used accounting variables are earning per share growth, return on equity, assets or investment over a period ranging from three to six years. These type of plans are commonly referred to as performance plans whereas the former one's are referred to as stock plans. There are several type' of such plans. The popularity of such plans depend upon host of factors the main among them are prevailing income tax laws, accounting treatment and the state of stock markets, corporate rules and regulations governing these plans etc: Some of the long term incentive plans are discussed below:

a) **Stock Option:** Under this plan a manager is given a right to buy a specified number of shares at or after a given date in the future (Exercise date) at a price agreed upon at the time the option is granted. This price is usually the prevailing market price. The major benefit of these type of incentives is that the efforts of the managers are directed towards both the shot term and longterm performance of the company. An outright purchase of equity under the stock option plan gives manager the equity which he can retain even if he chooses to leave the company. In these type of plan the equity purchased is subject to a lock in period ranging from three to five years. The main drawback of this plan is that there are many factors beyond the control of managers which determine the equity prices.

b) **Phantom Shares:** Under this plan the managers are allotted shares (notional shares) for book keeping purpose only: At the end of the specified period the manager receives an award equal to appreciation in the market value of the shares since allotment. This award may be in cash, in shares or a mix of both. The main advantage of this plan over the stock option plan is that it involves no transaction cost, there is no risk of decrease in market price of shares, purchased (during lock in period) and interest cost associated with holding the stock is absent.

c) **Stock Appreciation Rights:** Under this plan the manager is entitled to receive cash payment based on the increase in value of the stock from the time of award until a specified future date.

The stock appreciation rights and phantom shares are a form of deferred cashbonus in which the amount of bonus is a function of the market price of the 'company's share and both of these plans involve uncertainty regarding the amount of bonus.

d) **Performance** Shares: Under this plan the managers are awarded a specified number of shares when specific long term goals have been met.: Usually the goal is to achieve a specific increase in earning per share spanned over a period of three to five years. The merit of this plan is that the award is based on performance measures that can be at least partially controlled by the manager concerned. One of the drawback of this plan is that the bonus is based on performance measured by accounting measures which may not always bring out the true economic worth of the firm.

e) **Performance units;** In performance unit plan a cash bonus is paid on achieving specific long term targets. This plan is a combination of Stock Appreciation Rights and Performance shares. This type of plans are used by companies either in case , when they are, not listed on stock exchanges or if listed the trading is very thin. The success of this plan largely depends on how well the long term targets have been established.

10.3.3 Organisational Incentives

Individual incentive systems involve a direct relationship between the magnitude of output and the amount of financial reward and purports to accomplish the higher output per unit time, the organization wise incentive systems involve cooperation among employees, management and the union and purport to accomplish broader objecttves such as an organisation wide reduction in Iabour, material and supply costs, strengthening of employee loyalty to the company, harmonious labour-management relations and decreased turnover and absenteeism. There are three types of organization-wide incentive systems: (1) the Scanlon plan, (2) the Kaiser-United Steel workers plan, and (3) Profit sharing.

The Scanlon Plan

The Scan-Ion plan was devised by Joseph N. Scanlon who rose from an ordinary worker in a steel plant to a senior officer in the United steel workers of America and subsequently a lecturer at the Massachusetts institute of Technology. It purports to accomplish widespread employee participation, industrial harmony and increased productivity and involves a wage formula or incentive and a new type of suggestion system.

The wage formula relates to the distribution of earnings from increased productivity proportionately among all individuals involved including clerks, salesmen, supervisors and even in some cases middle and top level managers. Explicitly, the wage formula is tailor-made to suit the needs of specific organizations. However, wages are typically linked with the sales value of goods produced in a manner that I per cent increase in productivity is followed by 1 per cent increase in wages and salaries: This type of bonus forms not only an effective incentive to productivity but also a basis for participants to infer the extent of the organization's success.

The suggestion system relates to the establishment of production and screening committees to analyses employee suggestions and prepares general plans for improving productivity. The production. committee consists of a foreman and the production committee man selected or appointed by the union operating at the department level. The screening committee consists of top managers and union leaders and analyses employee's suggestions-which are rejected by the production committee as well as by those influencing the organization as a whole. Unlike the usual suggestion system, instead of rewarding the individual for accepted decisions, the entire group benefits **by** an increased bonus if the productivity increases as a result of the suggestions implemented. The individuals come forward with new suggestions instead of concealing them for fear or fight rates and the union renders its fall cooperation rather than

worrying for speed-up by the management. Moreover, the management itself suggests problems for mutual discussions rather than passively waiting for suggestions to emerge from employees. Again, both the quality and quantity of decisions are higher as compared to the usual suggestion system.

As Strauss and Sayles observe, despite several advantages of a successful Scanlon plan in the form of increased and improved suggestions, enhanced productivity and profits, reduced resistance to change, improved union management relations, increased intergroup and superior-subordinate cooperation and higher motivation to work. There are several conditions which must be accomplished before introducing it in the organization.

1) The management should improve its attitude and learn to consult workers and listen to severe criticism. In companies which practice general supervision and have an effective upward communication system, the Scanlon plan can be easily introduced while in others, it necessitates changes which the management is sometimes unwilling to make.

2) The Scanlon plan requires an initiative on the part of the unions to give up its militant attitude. However, it does not mean that they should ignore the grievances of individual employees in their *over* enthusiasm to push their members for working harder. Indeed, with active involvement in the plan, the union representatives are likely to be identified with the management ignoring the 'average members. This may cause passive support of the members and fall of there union leaders in the next election. The unions must resol^v^e this dilemma by explaining new development to the rank-and-file and paying heed to the reactions of their members.

3) The plan necessitates a high degree of group cohesiveness and employee identification with the organization as a whole. Obviously, in this system each individual's earning is dependent on the effort of the entire group. I-lard work by few individuals is likely to bring only negligible reward to them. Indeed, self-satisfaction, the desire for praise from the work associates and interest in the team are required to increase productivity. Sometimes, these factors are not likely to be present in the organization, and there may develop some rivalries among sub-groups. These difficulties are likely to increase in larger organizations.

4) The Scanlon plan has been effective, historically, in either depressed organizations where the employees struggle to save their jobs or in highly prosperous companies involving possibilities for earning huge bonuses. The plan may meet an utter failure where market conditions are too difficult to sell increased output and thus, enhanced productivity may cause unemployment to numerous individuals.

The Kaiser Plan

Kaiser-United Steel workers plan was devised in I963 by a committee consisting of company, union and public representatives with a view to eliminate the threats of strikes by equitably distributing the company's financial gains among the employees, the stockholders and the public, providing job and income securities to the workers in the face of technological innovations and accomplishing gradual elimination of wage inequities in some direct-wage incentive systems. The plan is characterized by guaranteed employment to workers against technological unemployment, sharing of the gains resulting from cost reduction in view of enhanced efficiency between the companies *(67.5* per cent) and the employees *(32.5* per cent), increases in wage rates and fringe benefits at least equivalent to bargained ones in the rest of the industry and **a** scheme for gradually eliminating direct wage incentives. As Beach points out, the

Kaiser plan which is principally in line with the Scanlon plan, has achieved mixed success. The company and the union in view of their evolving experiences with it have made several changes in the plan. The plan has been more effective during the early years than at present. Indeed, fluctuations in the market demand of the product of the company and in plant utilization have exerted adverse effects on the working of the plan in recent times.

Profit Sharing Systems

Profit sharing has been defined by the International Cooperative Congress, which met in Paris in 1889 as an agreement freely entered into, by which employees receive a share, fixed in advance, of the profits. Here are three types of profit sharing systems: (1) Current (cash) profit sharing, (2) deferred profit sharing; and (3) combination profit sharing.

Current or cash pro fit sharing system It involves payment of profits directly to the employees in cash, cheque or stock just after the determination of profits.

Deferred profit sharing system In deferred profit sharing system, profits are credited to the accounts of employees to be paid at retirement or other stated situations such as disability, etc.

Combination profit sharing system In combination profit sharing system, part of the profits is paid out currently in cash which part of it is deferred.

Profit sharing systems form a part of a progressive personnel policy embodying incentive characteristics and providing results not obtained from other systems. . Effective profit sharing increases profits, enhances efficiency and creates ,a climate for improved employee relations. Effectiveness of These systems is determined by the desire of the individuals involved to make them a success and likewise by the involvement of the top management.

Objectives

The major objective of the profit sharing system is to strengthen the unity of interest and the spirit of cooperation. They form an effective measure to solve the problem of divergent interests on the part of the workers and management. Specifically, **profit** sharing systems purport to: (1) inject a feeling of partnership between the employer and an employee, (2) provide a group incentive to the participants, (3) enhance employee security, (4) provide super-wage benefits without involving fixed commitments, (5) attract and retain effective resources, and (6) inspire employee thrift. As Dunn and Stephens point out, throughout the course of history of profit sharing, two objectives have prevailed. These include profit sharing as an incentive and profit sharing as a tool to develop a sense of partnership and commonality of interests. From the viewpoint of an employee, profit sharing accomplishes several objectives depending upon the type of systems adopted. While a cash system directly contributes to an employee's-immediate economic needs, deferred and combination system related to retirement, loss of income **in** view of disabilityy benefits to the dependents at the death of the employee and allied benefits. From the standpoint of the employer, the major objectives of profit sharing relate to increased productivity and employee satisfaction stemming from rewards to' satisfy their needs.

Mechanisms

Usually, the share of the total profits to be distributed among participants form a fixed percentage of the corporate net profits. Sometimes, it relates to the percentage of Profits prior to deduction for dividends and taxes, while at other times it involves a percentage subsequent to such deductions. At still other times, attempts are made to

express the amount paid to the individuals in terms of percentage of the dividends to stockholders. As soon as the volume of the entire fund for any one-year is calculated, care should be taken to immediately allocate the share of the individuals, frequently based upon the magnitude of their yearly earnings in relation to the total payroll of all the participants or their length of service and their wage levels.

Prerequisites

Beach describes several prerequisites to sound profit sharing systems.

1) Profit sharing should not be a substitute for adequate wages but provide something "extra" to the participants.

2) Before the introduction of the systems, care should be taken to ensure that there prevails satisfactory employer-employee relations and personnel practices are sound.

3) There must be some profits available for distribution among the participants and the enterprise should be free from continued losses.

4) Full support and cooperation of the union forms a major prerequisite to an effective profit sharing programmed.

Weaknesses

The major weakness of the program is that employee's earnings are linked with profits which are beyond their control and are influenced by numerous extraneous factors such as business cycles, amount of competition, ability of the top management and allied factors. However, historically profit sharing programs have been found to satisfy both the management and the employees.

Integrated Approach

In addition to the above three types of organizational incentives, attempts have been made to provide an integrated system employing different types of incentives. One of these attempts relates to the Lincoln Electric Company's incentive system introduced in 1934 which

involves nine components including a piece-work wage incentive plan with a guaranteed day rate, job-evaluated base rate, merit rating, cash profit sharing ,job security, stock purchase scheme for employees, advisory board, promotions and job enrichment.

Overall, as Beach concludes, programs of work incentives and labour management cooperation do not succeed exclusively because of an effective mechanical design. Indeed, an effective managerial leadership, a climate of trust and collaboration and mutuality of interests (in other words, the culture of the organization) form a vital prerequisite to effective incentive systems.

Group Incentive Plans

Under such plans, each member of the group receives a bonus based on the output of the group as a whole. There are several reasons for adopting such a plan. Sometimes (as on assembly lines) several jobs are inter-related. Here one worker's performance reflects not only his own effort but that of his co-workers too. In such cases, group incentive plans are advantageous. Secondly, such plans also encourage co-operation among group members. There tends to be less bickering among group members as to who has "tight" production standards and who has "loose" ones. Thirdly, the groups can bring pressure to bear on their members (through badgering, ostracis, etc.) and help

keep shirker in line. This, in turn, can help eliminate some of the need for close supervision. Fourthly, group production levels tend to be more stable than individual ones, and group incentive payments vary less than individual ones. Finally, group incentive plans also facilitate on-the-job training, since each member of the group has vested interest in getting a new group member trained as well as quickly as possible.

10.4 INCENTIVES FOR CORPORATE OFFICERS AND CHIEF EXECUTIVE OFFICER

In any economic environment it is always easy to measure the micro variables but always difficult to assess the macro picture due to the fact that many unmeasured and unexplained variables plays in formulating the macro scenario. This situation when applied to companies raises an important question; how do you measure the performance of corporate officers e.g. Chief financial officer, Vice President human resources, Vice President legal, Vice President Production. To be specific how one is going to measure the performance of staff function.

Each corporate officer except the Chief Executive Officer is responsible in part for the company's overall performance and these corporate officers are entitled to and are motivated by a-bonus for good performance. There is no set formula or method for measuring the performance of corporate officers. The usual practise is that the Chief Exectitive Officers recommends the awards to the compensation committee of the board of directors. These awards are based on the subjective assessment by the Chief Executive performance of each persons performance. In some companies Management By Objective System (MBO) is used in which specific objectives are agreed upon at the beginning of the year e.g. bringing attrition rate down by certain percentage, decreasing bad debts, decrease in working capital requirements, bringing down the idle time for plant and machinery etc. and the attainment of these objectives is assured by the Chief Executive Officer. More or less the incentives for senior level management are subjective in nature and this is more so evident in companies where ownership and management are not separate.

The Chief Executive compensation is an trick issue and much heat **has** been generated over this issue in recent past. The usual practise in deciding about CEO's compensation is as follows:

After the CEO has made presentation to the compensation committee of the board of directors regarding compensation to the corporate officers, the compensation committee decides about the CEO's incentive compensation. In usual practise the committee may simply apply the same percentage which the CEO has recommended for his subordinates, however, if the board wants to signal it's opinion of CEO's performance it may increase or decrease the percentage depending on performance of the CEO.

Activity 5

Try to find out the compensation structure of the corporate officers and CEO of your organization.

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10.5 INCENTIVES FOR BUSINESS UNIT MANAGERS

A wide array of options are available for developing an incentive compensation package for business unit managers. These options are displayed in Table 10.2.

Table 10.2: Incentive Compensation Design Options for Business Unit Managers

Table 10.2: Incentive Compensation Design Options for Business Unit Managers

A. Types of Incentives

1. Financial Rewards
   a. Salary increases
   b. Bonuses
   c. Benefits
   d. Perquisites
2. Psychological and Social Rewards
   a. Promotion possibilities
   b. Increased responsibilities
   c. Increased autonomy
   d. Better geographical location
   e. Recognition

B. Size of Bonus Relative to Salary

1. Upper Cutoffs
2. Lower Cutoffs

C. Bonus Based on

1. Financial Criteria
   a. Contribution margin
   b. Direct business unit profit
   c. Controllable business unit profit
   d. Income before taxes
   e. Net income
   f. Return on investment
   g. Residual income
2. Time Period
   a. Annual financial performance
   b. Multi year financial performance
3. Nonfinancial Criteria
   a. Sales growth
   b. Market share
   c. Customer satisfaction
   d. Quality
   e. New product development
   f. Personnel development
   g. Public responsibility
4. Relative Weights Assigned to Financial and Nonfinancial Criteria
5. Benchmarks for Comparison
   a. Profit budget
   b. Past performance
   c. Competitor's performance

D. Bonus Determination Approach

1. Formula-based
2. Subjective
3. Combination of the Two

E. Form of Bonus Payment

1. Cash
2. Stock
3. Stock Options
4. Phantom Shares
5. Performance Shares

Source: Robert N. Anthony and Vijay Govindarajan, The Management Control Process, Management Control Systems (1995), Irwin, pp. 563

10.5.1 Types of Incentives

Basically the incentives can be divided into two broad categories a) Financial b) Psychological and social. Financial incentives include salary increase, bonuses and perquisites whereas psychological and social incentives include promotion, increased responsibility, increased autonomy and recognition. Managers are motivated by both type of incentives, manager in their initial carrier path are motivated more by financial incentives whereas senior managers are more motivated by psychological and social incentives.

10.5.2 Size of Bonus Relative to Salary

The issue of size of bonus relative to the salary is governed by two contradicting philosophies. One school of thought lays stress on fact; Recruit good people---- ▸ Pay them well ----- ▸ Expect good performance. The other school of thought lays stress on the following process; Recruit good people. ----- ▸ Expect good performance ----- ▸ pay them well if performance is really good. The companies subscribing to this philosophy practise performance base pay which emphasises on incentives bonus rather than on pay. Since salary is an assured component emphasising on salary may lead to slackness, conservatism and complacency, whereas an emphasis on bonus or incentive pay tends to encourage entrepreneurship and innovation among managers which results in manager putting maximum efforts,

Cut off levels: A bonus plan may put the restriction at either of the end:

1) the level of performance at which maximum bonus is reached (upper cut off).

2) the level below which no bonus would be payable (lower cut off).

Both of these type of cutoffs may produce undesirable side effects. Suppose the level of performance is well below lower cutoff, there would be no motivation foro manager to improve the performance if in his opinion the performance level can't be reached above the lower cutoff. The managers would not put efforts to improve the performance level which are within the band of present performance and lower cutoff performance.

Similarly when the upper cutoff is reached the managers would not be interested to optimize the current profit rather they would be motivated to bring down the current profitability by overspending on discretionary expenses, thereby creating an opportunity for higher bonus in the next year.

One way to reduce such difunctional behaviour is to carry over excess or deficiency to the next year which would result into automatic adjustment of bonus. The bonus available for distribution in a given year would be bonus earned during that year plus any excess or minus any deficiency from the previous year.

10.5.3 Bonus Basis

In this secltion we are going to search an answer for the question; on what basis business unit manager's incentive bonus should be based? Whether is should be based on total corporate profit or solely on business unit profits or on some mix of the two.

The manager's actions and decisions have a direct impact on the performance of the business unit under his control, based on this the manager's incentive bonus should be linked to the performance of business unit under his control rather than that of other units. However, this type of approach would fail to build up synergy within the organization. Adopting this type of approach would create a managerial thinking which would be inward looking and somewhere the organizational goal would be lost.

In single business firms where the co-operation between various units is critical; since business units are highly interdependent the manager's bonus is tied to the overall performance of the company. This type of approach foster co-operation within various business units.

In a conglomerate basing the incentive bonus on the basis of corporate results would be counterproductive. In these type of organizations business units are autonomous. Basing the incentive bonus on the basis of company's profit would weaken the link between performance and reward. It would also give rise to another problem which is commonly known as problem of "free riders". A reward system based on company's profit would also reward those business unit managers who have contributed below average in the company's profit. Similarly business units giving excellent performance would not be rewarded; therefore, in conglomerates the incentive bonus should be based on units performance rather than overall company's performance.

For diversified firms it would be desirable to follow a system which bases itself on twill criteria of unit performance and company's performance. The mix may vary based on relative importance of the unit, unit's contribution towards profit of the company etc.

10.5.4 Performance Criteria

One of the main problems which arise while deciding about the incentive bonus is what set of criteria are to be used for evaluating the performance of business unit manager. How to segregate controllable and uncontrollable factors and what should be the quantum of allowance for uncontrollable factors. While a host of criteria are used for performance management, but a set of financial performance parameters always predominates any performance measurement scheme of business unit managers. We will briefly discuss these financial parameters.

Financial Criteria

The set of financial criteria to be used for performance measurement will depend upon how the business units are organised within the company. If the business unit is organised as profit center the choice of financial criteria include

1) Contribution margin
2) direct business unit profit
3) Controllable business unit profit
4) net income before taxes and net income.

In case the business unit is organised as Investment Centre the following financial criteria would be used:

1) definition of profit
2) definition of investment
3) choice between return on investment and residual income.

A detailed discussion about these parameters has been done in unit five and seven which deals with Profit Centre and Investment Centre respectively.

While using any financial criteria an adjustment regarding uncontrollable factors must be made**.** At the business unit level there are mainly two uncontrollable factors. for which adjustment need to be made

i) Adjust for the expenses which are the result of decisions made by managers about the business unit level.

ii) Adjust for the losses which are due to act of nature.

Benefits and Shortcoming of Short Term Financial Targets

Linking the bonus incentive to financial targets motivate the manager of the business unit to find ways and means to do things in a way which would have a positive impact on the top line as well as bottom line of the company. It fosters a spirit of entrepreneurship and innovation.

However, solely relying on financial targets has it's own pitfalls the major one being short terms decisions and actions will not be in sync with the long term goals. The managers may neglect crucial things like regular maintenance of plant and machinery, upgradation of skill set of human resource (Training and development), research and development activity etc. In addition to this the managers may defer investments that promises benefits in the long run but hurt short term financial results. Apart from this there is also a risk of managers engaging in data manipulation to meet current period targets.

In the long run all these factors would result in loss of market share and competitive edge.

In order to overcome the short term bias company's adopt the following practices.

1) Financial criteria are supplemented with additional incentive mechanism e.g. basing the bonus on multi year performance.

2) Financial criteria are supplemented with non financial criteria such as sales growth, increase in market share, customer satisfaction, product quality, new product development etc.

10.5.5 Bonus Determination Approach

A bonus award for business unit manager can be determined either objectively or subjectively or a combination of these two approaches. In objective approach the quantum of bonus is dependent on some measurable attribute of the business unit, e.g. a certain percentage of-the business units operating profit.

Exclusive reliance on objective based measurement has some clear advantages.

1) Reward system can be stated with precision leaving no room for ambiguity about performance standards.

2) Superior managers bias on favouritism will not come into play.

Exclusive reliance on objective measurement (output control) tend to neglect the various sub dimensions of the process which are important but difficult to measure and quantify, therefore, some amount of subjectivity is always desirable in determining bonus.

Subjective approach is useful in the following conditions:

i) when manager's personal control over units performance is low.

ii) when business units are interdependent, thereby reducing scope of action and autonomy..

iii) while pursuing strategic goals which requires trade off

iv) when business unit manager inherits problems created by a predecessor.

10.6 THE BENEFITS OF PERFORMANCE

DEPENDENT REWARD

The performance based rewards acts as an motivational tool and provide impetus for aligning employee's natural skill set and self interest with the organization's objective. They act as a control tool. The first control benefit is informational. The reward system act as a signaling device which signals about organizations priority. In any organization there would he certain variables demanding attention in form of time and resources such as cost, quality, customer service, asset management, future growth, market share etc. Al! these variables are mutually competing for internal resources for the organization. Reward system is based on measurable attribute and the organization by specifying that particular attribute; signals its priority; thereby helping managers to allocate resources. The second control benefit of rewards is motivational.

Performance dependent rewards also serves many non control purposes also some of which are listed below:

a) Reward are recruitment as well as retention tools. Performance based rewards which form a major part of compensation package are a signal to potential employee's and if it is comparable or superior as compared to competitors it helps in recruitment and retention of best available human resource,

b) A properly devised reward system can reduce the tax liability of both the employer and the employee.

c) Some reward systems are designed in such a way that they act as a defense mechanism against hostile takeover.

d) Some performance dependent rewards are designed in a way to make compensation variable with firms performance thus decreasing cash outlay when performance is poor and thereby reducing the company's operating beverage.

10.7 RESEARCH FINDING ON ORGANIZATION INCENTIVES

An important function of management control system is to align employees self interest with the organizational goal and this depends on relationship of organizational incentives to personal goals. Reward incentives are inducements to satisfy those needs that individual can't obtain without aligning his self interest with that of the organization. Organizations provide rewards to employees who perform in agreed upon ways. Research findings on rewards and incentives support the following:

- individuals are more motivated by the potential of earning rewards rather that fear of punishments thereby implying that management control system should be reward oriented.

- monetary rewards act as motivational tool up to a certain level beyond that their marginal utility declines thereby suggesting that for junior and middle level managers monetary rewards will act as a motivator but for senior managers non monetary rewards in form of recognition, autonomy, part of decision making process will act as a motivating factor.

- feedback is an important component of reward system. An objective and timely feedback will lead to achievement, self realization or to sense corrective actions that are needed to meet the objectives.

- the rewards should be timely, as a lapse of time between action and reward diminishes its effectiveness.

- for any reward system the targets should be realistic, unattainable targets or too Reward and Compensation easily attainable targets lack motivational impact.

- to make a desired impact, the targets of the reward system should be arrived through mutual consultative process between the superiors and subordinates. When goals are set through mutual consultative process the managers are able to extract a commitment and in all likelihood the commitment is going to be adhered to.

10.8 SUMMARY

Rewards and compensation will key management control device. Rewards that can be linked to performance or subjective performance evaluation comes in many forms. Both monetary and non monetary rewards are motivational. The incentive plans can be divided into two categories short term and long term incentive plans. Several considerations need to be taken into account while dividing the total bonus pool among business unit managers and corporate managers. While designing an incentive plan both external and internal factors should be taken care of. External factors are industry characteristics competitors compensation policy, managerial and labour market, tax and regulatory environment. The internal factors are value and beliefs of the employees who are rewarded the culture of the organization and the organizational strategies,

10.9 SELF ASSESSMENT QUESTIONS

1) How does the organization wide incentives plans differ from individual incentive plans.

2) Discuss in detail the various types of short term incentive plan.

3) Discuss in detail the various-types of long term incentive plan.

4) List out the underlying differences between short term and long term incentive plan.

5) Define the criteria on which the incentives of business unit managers are decided.

6) "While deciding about the incentive for business unit managers, there should be some scope for subjective evaluation."Comment.

7) Differentiate between the control and non control objectives of the performance dependent rewards.

10.10 FURTHER READINGS

Barry Gerhart and George T. Milkovich "*Organizational Differences"*. Academy of Management Journal, December 1990, pp 663-91

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Luis R. Gomej, Henry Tosi and Timothy Hinkin *"Managerial Control Performance and Executive Compensation"* Academy of Management Journal, March 1987, pp31-70s