Solutions for Compensation 13th Edition by Gerhart

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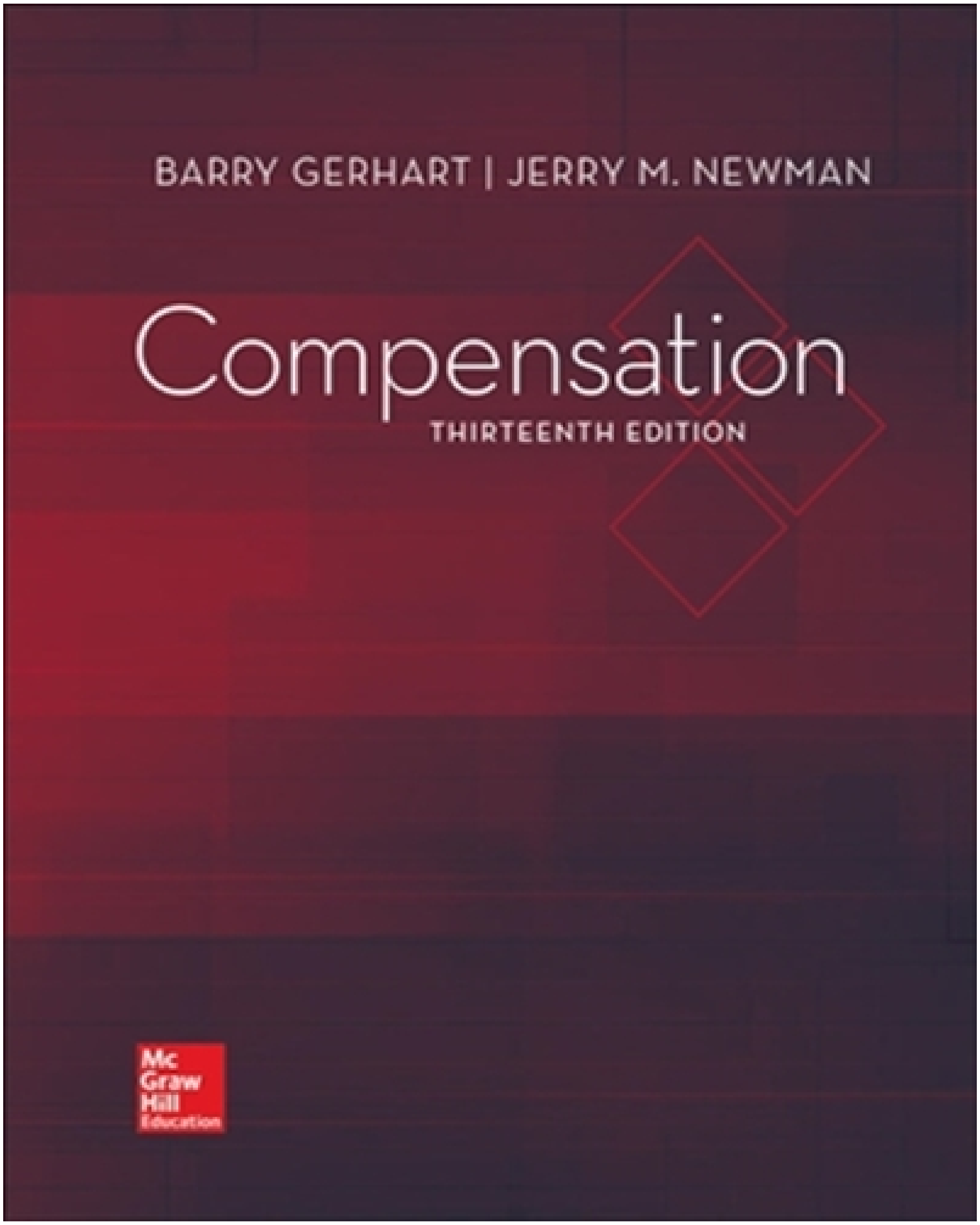

Solutions

CHAPTER TWO
STRATEGY: THE TOTALITY OF DECISIONS

Overview

This chapter examines the key aspects of decisions taken during the creation of compensation strategy. The key premise is that the way employees are compensated can be a source of sustainable competitive advantage. The three tests to identify if a pay strategy provides competitive advantage are discussed. The steps involved in developing a total compensation strategy are described: (1) assessing conditions; (2) deciding on the best strategic choices using the pay model (objectives, alignment, competitiveness, contributions, and management); (3) implementing the strategy through the design of the pay system; and (4) reassessing the fit. Two alternative approaches to developing a compensation strategy are highlighted: (1) “best-fit” and (2) “best-practices” approach. The best-fit approach presumes that one size does not fit all. Managing compensation strategically means fitting the compensation system to the business and environmental conditions. In contrast, the best-practices approach assumes a universal best way exists. The focus is not on what the best compensation strategy is but on how to best implement the system and ultimately fit the compensation system to the business and environmental conditions.

Learning Objectives

- Identify and describe similarities and differences in strategies within the same industry and within the same company.
- Discuss strategic choices that support business strategy and choices that support HR strategies.
- Describe a total compensation strategy in four steps.
- Apply the three tests for sources of competitive advantage.
- Compare best practices versus best fit and virtuous and vicious circles.

Lecture Outline: Overview of Major Topics

I. Similarities and Differences in Strategies
  A. Different Strategies within the Same Industry
  B. Different Strategies within the Same Company
II. Strategic Choices
III. Support Business Strategy
IV. Support HR Strategy
V. The Pay Model Guides Strategic Pay Decisions
  A. Stated versus Unstated Strategies
VI. Developing a Total Compensation Strategy: Four Steps
  A. Step 1: Assess Total Compensation Implications
  B. HR Strategy: Pay as a Supporting Player or Catalyst for Change?
  C. Step 2: Map a Total Compensation Strategy
  D. Steps 3 and 4: Implement and Reassess
VII. Source of Competitive Advantage: Three Tests
  A. Align
  B. Differentiate
  C. Add Value
VIII. "Best Practices" versus "Best Fit"?
IX. Guidance from the Evidence
X. Virtuous and Vicious Circles
XI. Your Turn: Merrill Lynch
XII. Still Your Turn: Mapping Compensation Strategies

Lecture Outline: Summary of Key Chapter Points

I. Similarities and Differences in Strategies

- Compensation strategies of three companies (Google, Nucor, and Merrill Lynch) are compared and contrasted.
    - All three are innovators in their industry.
        - Their decisions on the five dimensions of compensation strategy (objectives, internal alignment, externally competitive, employee contribution, and management) are both similar and different.
    - All three formulate their pay strategy to support their business strategy.
        - All three emphasize outstanding employee performance and commitment.
    - However, there are major differences (See Exhibit 2.1).
- While Google is one of the largest companies in the world, it positions itself as still being, at heart, the feisty start-up populated by nerds and math whizzes.
    - It offers all its employees such generous stock options that many of them have become millionaires.
    - Its benefits are "way beyond the basics" compare to its competitors.
- Nucor Steel is a pioneer in recycling steel scrap and other metals into steel products. The emphasis is on high productivity, high quality, and low cost products.
    - Nucor provides an opportunity for those who are willing to work hard to make a lot of money by helping the company be productive and profitable.
    - In a good year, an hourly worker can make $75,000 or more in wages and bonuses combined.
        - Compare that to an average annual wage in U.S. manufacturing of about $47,000.
    - In addition, Nucor has had no layoffs.
        - When steel prices are low, bonuses are lower.
        - Nucor's labor costs are flexible downward when necessary, but that flexibility is not achieved through use of layoffs.
- Merrill Lynch, now part of Bank of America, relies heavily on the human capital of its employees to compete.
    - Pay objectives are straightforward: to attract, motivate, and retain the best talent.
        - Brokers are paid bonuses on a sliding scale for up to 50% of the broker's annual commissions (called production).
        - There may also be incentives for team production, adding new clients, and growth in production.
    - The aggressive pay-for-performance approach is now seen as a key factor in the meltdown of the financial industry.
        - Yet Merrill Lynch routinely produces a disproportionately high share of Bank of America overall net income.

- These three companies operate in very different industries and face different condition, serve different customers, and employ different talent.
  - So, the differences in their pay strategies may not be surprising.
  - Pay strategies can also differ among companies competing for the same talent and similar customers.

A. Different Strategies within the Same Industry

- Google, Microsoft, and SAS all compete for software engineers and marketing skills but they focus on different components of an employees' compensation.
- In its earlier years, Microsoft adopted a very similar strategy to Google's, except its employees accepted less base pay to join a company whose stock value was increasing exceptionally.
  - But, when its stock quit performing so spectacularly, Microsoft shifted its strategy to increase base and bonus to the 65th percentile from the 45th percentile of competitors' pay.
  - It retained its strong emphasis on (still nonperforming) stock-related compensation, but eliminated its longstanding, broad-based stock option plan in favor of stock grants.
  - More recently, Microsoft scaled back its stock awards, replacing that with cash. Its benefits continue to lead the market.
- SAS Institute, the world's largest privately owned software company, takes a different approach.
  - It emphasizes work/life programs over cash compensation and provides limited bonuses and no stock awards.
  - SAS includes free onsite child care centers, subsidized private schools for children of employees, doctors on site for free medical care, plus recreation facilities. Working more than 35 hours a week is discouraged.

B. Different Strategies within the Same Company

- Sometimes different business units within the same corporation face very different competitive conditions, adopt different business strategies, and thus fit different compensation strategies.
  - For example, the Korean company SK Holdings has much variety in its business units.
    - They include a gasoline retailer, a cellular phone manufacturer, and SK Construction.
  - SK has different compensation strategies aligned to each of its very different businesses.
- A simple "let the market decide our compensation" strategy does not work internationally.
  - In many nations, markets do not operate as in the United States or may not

even exist.
    - Emerging labor markets in some developing countries and highly regulated labor markets in some developed countries are responsible for less movement of people among companies than is common in the U.S., Canada, or even Korea, and Singapore.
- Strategic perspective on compensation is more complex than it first appears.

II. Strategic Choices

- **Strategy** refers to the fundamental directions that an organization chooses.
    - An organization defines its strategy through the tradeoffs it makes in choosing what (and what not) to do.
- Exhibit 2.2 ties the strategic choices to the quest for competitive advantage.
    - At the corporate level, the fundamental strategic choice is: *What business should we be in?*
    - At the business unit level, the choice shifts to: *How do we gain and sustain competitive advantage in this business?*
    - At the function level the strategic choice is: *How should total compensation help this business gain and sustain competitive advantage?*
- The ultimate purpose—the "so what?"—is to gain and sustain competitive advantage.

Definition: A **strategic perspective** focuses on those compensation choices that help the organization gain and sustain competitive advantage.

III. Support Business Strategy

- A currently popular theory proposes that pay systems align with an organization's business strategy. The rationale is based on contingency notions.
    - Differences in a firm's strategy should be supported by corresponding differences in its human resource strategy, including compensation.
    - The underlying premise is 'the greater the alignment, or fit, between an organization's strategy and the compensation system, the more effective the organization.
- Exhibit 2.3 gives an example of how compensation systems might be tailored to the three general business strategies.
    - The **innovator** strategy stresses new products and short response time to market trends.
        - A supporting compensation approach places less emphasis on evaluating skills and jobs and more emphasis on incentives designed to encourage innovations.
    - The **cost cutter** strategy focuses on efficiency, doing more with less, and minimizing costs.

        - It encourages productivity increases, and specifying in greater detail exactly how jobs should be performed.
    - The **customer focused** strategy stresses delighting customers and bases employee pay on how well they do this.
- Compensation strategies can also be based on generic strategy frameworks:
    - Michael Porter's business strategy framework would label firms that cut costs to follow a *cost leadership strategy* and those that seek to provide a unique or innovative product at a premium price to follow a *differentiation strategy*.
    - Miles and Snow's framework refer to *defenders* as those companies that operate in stable markets and compete on cost, and *prospectors* focus on innovation and new markets.
- Conventional wisdom would be that competing on cost requires lower compensation, whereas competing through innovation is likely to be more successful with high-powered incentives/pay for performance.
- Most firms, however, do not have generic strategies. Instead, they tend to have aspects of cost and innovation.
- Likewise, compensation strategies do not necessarily line up neatly with generic business strategies.
    - For example, Nucor and Southwest Airlines rely heavily on cost leadership in their strategies, but pay their employees well above market (e.g., using stock and profit sharing plans) when firm performance is strong.
    - SAS follows a customer and innovation strategy, but uses little in the way of pay for performance.
- To do better than competitors, a firm must consider how to fashion its own unique way of adding value through matching its business strategy and pay strategy.
    - Looking at Exhibit 2.3, Google might fit as an innovator, Merrill Lynch as customer focused, and Nucor an innovator as well as a dedicated cost cutter and productivity-focused.
    - However, managers of these companies might say that they are a unique blend of the three strategies.
- If an organization changes its business strategy, the pay systems should change.
    - A classic example is IBM's strategic and cultural transformation is discussed in the text.
    - For years, IBM emphasized internal alignment which worked well when the company dominated the market but provided little flexibility to adapt to competitive changes.
    - A redesigned IBM focuses on the high-growth, high-value segments of the IT industry. A new business strategy meant a new compensation strategy.
        - They cut layers of management to streamline the organization.
        - They redesigned jobs to build in more flexibility.

    - They increased incentive pay to more strongly differentiate on performance.
    - They kept a constant eye on costs.
- Exhibit 2.4 depicts IBM's "New Blue" approach to executing its strategy.
  - It is unclear if the strategy is working, IBM's stock price is down 19% over the last five years, in contrast to an increase of 66% in the Dow Jones Index over the same period.

IV. Support HR Strategy

- A compensation strategy that supports the business strategy implies alignment between compensation and overall HR strategies.
  - In the literature on high-performance work systems (HPWS) and HR strategy, researchers Boxall and Purcell have found a commonly used performance theory.
    - They refer to this as the "AMO theory," given by ***P* = *f* (A, M, O)**.
    - The theory states that performance (*P*) is a function (*f*) of three factors: **ability** (*A*), **motivation** (*M*), and **opportunity** (*O*).
  - Compensation is the key to attracting, retaining, and motivating employees with the abilities necessary to execute the business strategy and handle greater decision-making responsibilities.
  - Compensation is also the key to motivating them to fully utilize those abilities.
  - Higher pay levels and pay for performance are often part of such a HPWS.
- Compensation strategy and HR strategy are central to successful business strategy execution.
  - Exhibit 2.5 seeks to capture that idea, the importance of AMO and fit.
  - This in turn influences the revenues and costs of the company.

V. The Pay Model Guides Strategic Pay Decisions

- Using the pay model, the five strategic compensation choices facing Whole Foods managers will be:
  - *Objectives*: How should compensation support the business strategy and be adaptive to the cultural and regulatory pressures in a global environment?
    - Whole Foods objectives:
      - Increase shareholder value through profits and growth.
      - Go to extraordinary lengths to satisfy and delight customers.
      - Seek and engage employees who are going to help the company make money.
  - *Internal Alignment*: How differently should the different types and levels of skills and work be paid within the organization?
    - Whole Foods:

- Store operations are organized around self-managed teams.
- Executive salaries do not exceed 19 times the average pay of full-time employees.
- All full-time employees qualify for stock options and 94% of options go to nonexecutive employees.

- *External Competitiveness*: How should total compensation be positioned against competitors? What **forms of compensation** should be used?
  - Whole Foods:
    - Offers a unique total compensation package compared to competitors. They provide health insurance to full-time employees and 20 hours of paid time a year to do volunteer work.
- *Employee Contributions*: Should pay increases be based on individual and/or team performance, on experience and/or continuous learning, on improved skills, on changes in cost of living, on personal needs, and/or on each business unit's performance?
  - Whole Foods:
    - Uses a shared fate technique where monthly team performance, in terms of revenue per hour worked, directly affects what the team is paid.
- *Management*: How open and transparent should the pay decisions be to all employees? Who should be involved in designing and managing the system?
  - Whole Foods:
    - Uses a "No-secrets" management technique where every store provides salary amounts for every employee, including executives.
    - Using "You Decide," employees chose to pick their health insurance rather than have one imposed by leadership.

- These decisions, taken together, form a pattern that becomes an organization's compensation strategy.

A. Stated versus Unstated Strategies

- All organizations that pay people have a compensation strategy. Some have a written compensation strategy shared with all employees.
- The compensation strategy of other organizations emerges from the pay decisions they make.
- Managers in all organizations make the five strategic decisions (objectives, internal alignment, externally competitive, employee contribution, and management).
- Some do it in a rational, deliberate way, while others do it more chaotically—as ad hoc responses to pressures from the economic, sociopolitical, and regulatory context in which the organization operates.

VI. Developing a Total Compensation Strategy: Four Steps

- Exhibit 2.6 shows the four simple steps involved in developing a compensation strategy.
  - While the steps are simple, executing them is complex.
  - Trial and error, experience, and insight play major roles.
  - Research evidence can also help.

A. Step 1: Assess Total Compensation Implications

Business Strategy and Competitive Dynamics—Understand the Business

- This first step includes an understanding of the specific industry in which the organization operates and how the organization plans to compete in that industry.
  - This corresponds with the first two decisions in Exhibit 2.2: What business should we be in, and how do we win in that business?
- Learn to gauge the underlying dynamics in the business (or build relationships with those who can).
  - Different compensation strategies must align with different business strategies.
- Competitive dynamics can be assessed globally.
  - However, comparing pay among countries is complex.
  - Nevertheless, managers must be knowledgeable about competitive conditions even locally.

HR Strategy: Pay as a Supporting Player or Catalyst for Change?

- Whatever the overall HR strategy, a decision about the prominence of pay in that HR strategy is required.
- Pay can be a supporting player, as in the high-performance approach, or it can take the lead and be a catalyst for change.
- Whatever the role, compensation is embedded in the total HR approach.

Culture/Values

- A pay system reflects the values that guide an employer's behaviors and underlie its treatment of its employees; a pay system thus mirrors a company's image and reputation.
- Exhibit 2.7 shows a portion of Medtronic's values statement.

Social and Political Context

- *Context* refers to a wide range of factors—legal and regulatory requirements, cultural differences, changing workforce demographics, and employee expectations.

    - These also affect compensation choices.
  - Because governments are major stakeholders in determining compensation, lobbying to influence laws and regulations can also be part of a compensation strategy.
    - So, from a strategic perspective, compensation managers shape the sociopolitical environment as well as are shaped by it.

Employee Preferences

  - Employees have different needs and wants which are easily overlooked when formulating a compensation strategy.
  - A major challenge in the design of next-generation pay systems is how to better satisfy individual needs and preferences—offering more choice is one approach.

Choice is Good. Yes, No, Maybe?

  - Contemporary pay systems in the United States do offer some choices including flexible benefits and choices among health care plans.
  - Some studies have found that people do not always choose well.
    - They do not always understand the alternatives, and too many choices simply confuse them.
  - In addition to possibly confusing employees, unlimited choice would be a challenge to design and manage.
    - Unlimited choice may also meet with disapproval from the U.S. Internal Revenue Service (health benefits are not viewed by the IRS as income).

Union Preferences

  - Pay strategies need to be adapted to the nature of the union-management relationship.
  - Although union membership among private-sector workers in the U.S. is less than 7%, unions do influence pay decisions.
  - Unions' interests can differ.
  - Compensation deals with unions can be costly to change.

B. Step 2: Map a Total Compensation Strategy

- A compensation strategy is formulated based on the five elements of the pay model: objectives, and the four policy choices of alignment, competitiveness, contributions, and management.
- Mapping is often used in marketing to clarify and communicate a product's identity.
- Exhibit 2.8 maps the compensation strategies of Microsoft and SAS.
  - Each company's profile on the strategy map reflects its main message or "pay

brand."

- Microsoft: Total compensation is prominent, with a strong emphasis on market competitiveness, individual accomplishments, and performance-based returns.
- SAS: Total compensation supports its work/life balance. Competitive market position, company-wide success sharing, and egalitarianism are the hallmarks.

- Strategic maps provide a visual reference.
  - They are useful in analyzing a compensation strategy that can be more clearly understood by employees and managers.
  - Maps *do not* tell which strategy is "best." Rather, they provide a framework and guidance.
- It is important to realize that the decisions in the pay model work in concert. It is the totality of the decisions that forms the compensation strategy.

C. Steps 3 and 4: Implement and Reassess

- Step 3 in Exhibit 2.6 is to implement the strategy through the design and execution of the compensation system.
  - The compensation system translates strategy into practice – and into people's bank accounts.
- Step 4, reassess and realign, closes the loop.
  - This step recognizes that the compensation strategy must change to fit changing conditions.
  - Thus, periodic reassessment is needed to continuously learn, adapt, and improve.

VII. Source of Competitive Advantage: Three Tests

- Three tests determine whether a pay strategy is a source of competitive advantage.
  1. Is it aligned?
  2. Does it differentiate?
  3. Does it add value?

A. Align

- Alignment of the pay strategy includes three aspects:
  1. Align with the business strategy,
  2. Align externally with the economic and sociopolitical conditions, and
  3. Align internally with the overall HR system.
- Alignment is probably the easiest test to pass.

B. Differentiate

- Some believe that the only thing that really matters about a strategy is how it is different from everyone else's.
  - If the pay system is relatively simple for any competitor to copy, then how can it possibly be a source of competitive advantage?
- The answer according to the advocates of the strategic approach, is in how the pay system is managed.
  - The map profiles in Exhibit 2.8 show how Microsoft and SAS differ in their strategies.
  - One uses pay as a strong signal; the other uses pay to support its work/family balance HR strategy.
  - Both claim to value performance, yet their compensation strategies differ.
- It is difficult for a company to imitate the compensation strategy of another company since each strategy is woven into the fabric of a company's overall HR strategy.
  - Copying one or another dimension of a strategy means ripping apart the overall approach and patching in a new one.
  - So, in a sense, the alignment test (weaving the fabric) helps ensure passing the differentiation test.

C. Add Value

- Compensation is often a company's largest controllable expense
- Since consultants and a few researchers treat different forms of pay as investments, the task is to come up with ways to calculate the return on those investments (ROI).
- Trying to measure an ROI for any compensation strategy implies that people are "human capital," a view that some people find dehumanizing.
  - They argue that viewing pay as an investment with measurable returns diminishes the importance of treating employees fairly.
- Of the three tests of strategy—align, differentiate, add value—the last is the most difficult to "pass."
- Are there advantages to an innovative compensation strategy?
  - In products and services, first movers (innovators) have well-recognized advantages that can offset the risks involved—high margins, market share, and mindshare (brand recognition).
  - But, it is not yet proved whether such advantages accrue to innovators in total compensation.

VIII. "Best Practices" versus "Best Fit"?

- The premise of any strategic perspective is that if managers align pay decisions with the organization's strategy and values, are responsive to employees and union relations, and are globally competitive, then the organization is more likely to achieve competitive advantage.
- In contrast to the notion of strategic fit, some believe that (1) a set of **best-pay practices** exists and (2) these practices can be applied universally across situations.
  - Rather than having a better fit between business strategy and compensation plans that yields better performance, they say that best practices result in better performance with almost any business strategy.
- The authors believe that adopting best-pay practices allows the employer to gain preferential access to superior employees.
  - These superior employees will in turn be the organization's source of competitive advantage.

IX. Guidance from the Evidence

- There is consistent research evidence that the following practices do matter to the organization's objectives.
  - *Internal alignment*: smaller internal pay differences and larger internal pay differences can both be a "best" practice.
  - *External competitiveness*: paying higher than the average paid by competitors can affect results.
  - *Employee contributions*: performance-based pay can affect results. An associated question such as "Are performance incentives a "best" practice?" is contextual in nature.
  - *Managing compensation*: rather than focusing on only one dimension of the pay strategy, all dimensions need to be considered together.
  - *Compensation strategy*: embedding compensation strategy within the broader HR strategy affects results. Compensation does not operate alone; it is part of the overall HR perspective.
- Specific pay practices appear to be more beneficial in some contexts than in others.
- Thus, best practice versus best fit does not appear to be a useful way to frame the question.
- A more useful question is, "What practices pay off best under what conditions?"

X. Virtuous and Vicious Circles

- One study reported that while *pay levels* (external competitiveness) differed among companies, they were not related to a company's subsequent financial performance.
- This study concluded that it is not only *how much* you pay but also *how* you pay that matters.

- Exhibit 2.9 suggests that performance-based pay works best when there is success to share.
  - Performance-based pay that shares success with employees does improve employee attitudes, behaviors, and performance (when coupled with the other “high-performance” practices).
  - When organization performance declines, performance-based pay plans do not pay off; there are no bonuses, and the value of stock declines—with potentially negative effects on organization performance.
  - Unless the increased risks are offset by larger returns, the risk-return imbalance will reinforce declining employee attitudes and speed the downward spiral.
  - These studies do seem to indicate that performance-based pay may be a best practice, under the right circumstances.

XI. Your Turn: Merrill Lynch

Summary of Case

The case profiles the financial crisis at Merrill Lynch at the end of the last decade, which was acquired by Bank of America for $50 billion. B of A received government assistance during the financial crisis from (and was covered by) TARP (the Troubled Asset Relief Program). One initial consequence of TARP coverage was that some employees, including some high-level, high-revenue generating employees, began to leave larger financial institutions like Merrill Lynch/Bank of America to go to so-called “boutique” financial services firms, which had not received TARP money and thus were not covered by TARP restrictions on compensation. Another initial reaction was an increase in base pay levels and a decrease in bonus levels, apparently in response to all of the negative publicity bonuses had received and as a way to get around TARP restrictions. Students are expected to analyze the decision of Merrill Lynch to change employee compensation just to get around TARP restrictions on compensation.

However, now, that some time has passed, the economy has recovered (somewhat), and the stock market has bounced back, Merrill Lynch and other financial services companies are making money again. At Merrill Lynch, there is always a lot of action and discussion around compensation strategy. Merrill introduced a plan to expand its number of financial advisors by 8 % (about 1,200 people). Where would they come from? Other firms? How would Merrill get them to move? By offering unusually high up-front signing bonuses and decentralizing authority. Traditionally, top brokers from other firms can receive 1.5X their pay at the firm they are leaving. Merrill was not the only firm looking to add top brokers. Indeed, what was described as a “bidding war” broke out, and signing bonuses were reported to have gone as high as 3X or 4X previous pay in some cases. Why the bidding war? “Wealth management firms make the bulk of their profits on the top 10% of their producers” according to compensation attorney Katten Muchin. And, very wealthy clients tend to be more loyal to their advisors than to the advisors’ firms.

Learning Objective

Analyze the decision to provide higher base salaries instead of bonuses.

Discussion of Case Issues

At Merrill, there are some concerns among financial advisors. First, in the non-Merrill part of Bank of America, brokers are under a discretionary bonus system rather than an (objective) incentive system where pay is based on a formula. Merrill financial advisors fear that Bank of America wants to extend that system to cover them. Second and likely related, non-Merrill brokers at B of A are expected to cross-sell—in other words, to push products sold by other parts of the bank. The opportunities for such synergies are typically seen as a source of competitive advantage for a large, diversified financial institution such as B of A. However, cross-selling performance (and cooperation) is difficult to assess objectively. Thus, subjective evaluations are likely necessary. Merrill brokers appear to be opposed to cross-selling, both because they are concerned it could undermine their relationships with their clients and they prefer to have their pay determined by objective measures.

Teaching Guidelines

Use this case to stimulate a discussion assessing the compensation implications of providing higher base salaries instead of bonuses.

Student answers may vary. Students can consider the following inputs in constructing their answers.

1. **What is the likely result of bidding wars of this type for top brokers? Will most firms benefit? Who will be the winners and losers? What about the brokers?**
    - The bidding war is beneficial to top brokers, as most of the big firms are not retreating from it. Since investors are still worried about making investments, big firms are enthusiastic about appointing big brokers.
    - Research suggests that the bidding war is advantageous to the shareholders of target firms. The advantages for the shareholders in the acquiring firms are different for each takeover.
    - Bidding wars result in a rise in the price of the shares of the target firm. The acquiring firm pays a price, which results in a normal return with a risk premium.
    - The brokers will also secure gains from the bidding war because every big firm is obsessed with offering huge bonus amounts to brokers, as they are very eager to manage the assets of the wealthy sections of the society. Also firms are interested in providing brokers with bonuses as brokerage business is known to be more profitable today,

compared to trading and investing.

Source:
http://www.reuters.com/article/2012/04/10/us-bonusbubble-brokers-idUSBRE8391EV20120410

2. **Explain why there is such a strong relationship between pay and performance for brokers. Why isn't this true of many other jobs?**
    - The performance of brokers determines their pay. Big firms are ready to pay brokers high bonuses as well as perks such as hiring of assistants, etc. The firms are spirited about appointing brokers because investors are still not ready to make investments. Hence, brokers are motivated to excel in their activities and secure their payments.
    - This is not true of many other jobs because if a certain broker does not perform well and achieves targets, its client, (the firm that assigns brokerage), will easily appoint another broker and offer greater bonus amounts.

    Source:
    http://www.reuters.com/article/2012/04/10/us-bonusbubble-brokers-idUSBRE8391EV20120410

3. **Should Bank of America change its compensation strategy to include more subjective assessments of performance and a greater emphasis on cross-selling? What effect might this have on its success in the bidding war for top brokers?**
    - A subjective assessment of performance refers to evaluation of intangible qualities of employees and is based on subjective feedback from supervisors instead of objective, measurable feedback. Cross-selling refers to the action of selling among clients with whom contact has already been established or the activity of selling an additional product or service to an existing customer.
    - If Bank of America changes its compensation strategy to include more subjective assessments of performance, employees' compensations will be based on their personal qualities such as their, attitudes, communication skills, etc. rather than their technical performance. Also, this assessment will evaluate employees using a scale consisting of poor and excellent, as opposed to objective assessments which use numerical scores. A greater emphasis on cross-selling would help Bank of America obtain greater value and more revenue from its clients. Also, if it sells multiple services to its client, it can prevent competition from other firms.
    - Merrill brokers appear to be opposed to cross-selling, both because they are concerned it could undermine their relationships with their clients. They also appear to prefer to have their pay determined by objective measures. However, cross-selling will definitely have a competitive advantage for a large, diversified financial institution such as Bank of America and since cross-selling is difficult to be assessed objectively, a subjective

assessment of performance is a good option.

Source:
http://smallbusiness.chron.com/subjective-performance-evaluation-20453.html
http://en.wikipedia.org/wiki/Cross-selling

4. **In chapter 1, we talked about incentive and sorting effects of pay strategies. Describe the incentive and sorting effects at Merrill Lynch and how changes to the compensation strategy might affect them.**
   - Incentive effect refers to the degree to which pay influences individual and aggregate motivation among the employees we have at any point in time. The incentive effect can be seen at Merrill Lynch where the firm offers bonus based on individual, unit and company success. The firm differentiates on bonuses and stock. In high-profit years, top bonuses are significantly larger. In less-profitable years, top performers' bonuses decrease much less than poorer performers.
   - Under the sorting effect, different types of pay strategies may cause different types of people to apply to and stay with (i.e., self-select into) an organization. In the case of pay structure/level, it may be that higher pay levels help organizations to attract more high-quality applicants, allowing them to be more selective in their hiring. Similarly, higher pay levels may improve employee retention. Less obvious perhaps is the fact that it is not only how much, but how an organization pays that can result in sorting effects. People differ regarding which type of pay arrangement they prefer. Merrill Lynch aims to attract, motivate, and retain the best talent. It has fair, understandable policies and practices. People most probably apply to and stay with Merrill Lynch on account of the fair pay system. Jobs at Merrill Lynch are based on four factors, knowledge/skill, complexity, business impact, and strategic value. Also, the management at Merrill Lynch is understandable and maintains a consistent message.

5. **Have a look at the most recent changes to Merrill Lynch's compensation plan for its financial advisors. Why have these changes been made (what are the goals) and how well do you expect them to work (and why)?**

   Answer: Merrill Lynch is in a business where human capital is the main cost, as well as the key to revenue generation. Thus, it seeks to attract and retain high performing brokers, who are key to generating revenue. Broker performance (revenue generated) is easier to measure objectively and accurately than it is in many other occupations. That makes it more feasible to use strong incentive intensity where broker pay is tied directly in formulaic way to the amount of revenue they generate. Merrell Lynch has also increasingly realized that firm level revenue can be greater than the simple sum of revenue generated by each individual broker. However, to maximize firm level revenue, Merrell Lynch believes it is necessary for incentivize brokers to also help the firm exploit revenue opportunities in other parts of the firm (including engaging in cross-selling). Not all brokers are enthused about that system, which is not surprising given that most brokers decided to join and remain with Merrell Lynch because of the compensation and incentive system that was in place in the past when they joined. Finally, one might ask the students to check recent stories on Merrell Lynch to see if any additional changes have been made to broker compensation and how brokers are reacting.

XII. Still Your Turn: Mapping Compensation Strategies

Summary of Case

Using the concept of strategic mapping, students should describe the compensation strategy for any organization of their choice and compare it with the compensation strategies of Microsoft and SAS. Use Exhibit 2.8.

Learning Objective

Utilize the concept of strategic mapping to provide a picture of a company's compensation strategy (involves the five decisions contained in pay model).

Discussion of Case Questions

1. Summarize the key points of your company's strategy.
2. What are the key differences compared to the strategies of Microsoft and SAS?

Alternatively, ask several managers in the same organization to map that organization's compensation strategy. You will probably need to assist them in completing the map. Then compare the managers' maps.

3. Summarize the key similarities and differences.
4. Why do these similarities and differences occur?
5. How can maps be used to clarify and communicate compensation strategies to leaders? To employees?

Teaching Guidelines

Use this case to analyze and understand the differences between the compensation strategies of different companies using strategic mapping as a tool.

The best way to approach this case is to coordinate the discussion based on the dimensions and concepts presented in Exhibit 2.8. The information provided in Exhibit 2.1 is also useful in discussing this case. Then, spend some time comparing and contrasting the differences between

Microsoft and SAS with respect to the five dimensions: objectives, alignment, competitiveness, employee contributions, and management.

Objectives: Prominence—how important is total compensation in the overall HR strategy? Is it a catalyst, playing a lead role? Or is it less important, playing a more supporting role compared to other HR programs. At Microsoft, compensation is rated highly prominent, while at SAS it is more supportive.

Alignment: This is described in terms of flexibility, degree of internal hierarchy, and how well compensation supports career growth. Both Microsoft and SAS use pay to support flexible work design and promotions. Differences occur in the area of internal hierarchy—Microsoft is more individual-oriented compared to SAS, whose focus is on teams and the philosophy of “everyone is part of the SAS family.”

Competitiveness: This is described as total pay relative to what competitors offer (how much?) and the importance of incentives relative to base pay (what forms?). The importance of work/life balance achieved via benefits and services is also included. Microsoft’s competitiveness position is critical to its pay strategy. While it emphasizes both base pay and bonuses (base pay and bonuses are pegged to the 65th percentile of competitors), it is less concerned with policies related to work/life balance. SAS competes on factors other than total pay. While it uses options and bonuses tied to performance, the amounts are smaller than those at Microsoft. SAS’s strategy emphasizes a greater balance among cash compensation, options, and a generous package of work/life balance programs.

Contributions: This dimension focuses on the basis of pay increases—individual and/or team performance—and the mix of pay forms (base pay, incentives, merit, bonus, and stock options). The two companies take a very different approach to performance-based pay. Microsoft is a heavy user of pay based on individual performance while SAS emphasizes team- and group-based success sharing. It does not offer individual incentives except for a few extraordinary contributors

Management: This is described in terms of ownership (non-HR managers’ role in managing pay), transparency (openness and communication about pay), technology (software support to administer pay), and the degree of employee choices and customization. Both Microsoft and SAS rate high on the use of technology to manage the pay system, and Microsoft offers greater choices in their health care and retirement investment plans. In Microsoft, total compensation is prominent, with a strong emphasis on market competitiveness, individual accomplishments, and performance-based returns. In SAS, total compensation supports its work/life balance. Competitive market position, companywide success sharing, and egalitarianism are the hallmarks.

The above discussion of the differences and similarities between Microsoft and SAS can serve to provide a framework for the responses to questions 1 and 2 under both potential assignments for this case assignment. Once they understand the dimensions of strategic mapping, they should apply this knowledge to the company selected in either assignment.

In response to question 3 under the second assignment (how can maps be used to clarify and communicate compensation strategies to leaders and employees?), it should be pointed out that strategic maps provide a visual reference. They are useful in creating a compensation strategy that is focused and clearly understood by employees and managers. They can be used to achieve consensus on what the pay strategy should be.

Answers to Review Questions

1. **Select a familiar company or analyze the approach your college uses to pay teaching assistants or faculty. Infer its compensation strategy using the five dimensions (objectives, alignment, competitiveness, employee considerations, and management). How does your company or school compare to Microsoft and Merrill Lynch? What business strategy does it seem to "fit" (i.e., cost cutter, customer centered, innovator, or something else)?**

   Student answers may vary.
   The best way to organize the answer to this question is to construct a table similar to the one in Exhibit 2.1. Then, spend some time comparing and contrasting the differences between Microsoft and Merrill Lynch with respect to the five issues. While the objectives are similar, there are differences in how they translate into action. Microsoft's objectives are to support the business objectives and support recruiting, motivation, and retention. Merrill Lynch's objectives are to focus on customer, attract, motivate, and retain the best talent using fair, understandable policies and practices. Microsoft would place greater emphasis on retention since the types of skills it employs require a longer lead-time for training and are also more expensive. At Merrill Lynch, financial services offered to clients and companies take on a vast significance to their employees, since pay for performance is largely stressed upon. With respect to internal alignment, Merrill Lynch emphasizes differences in pay, using an egalitarian structure. At Microsoft internal alignment must support a performance-driven structure; less emphasis would be placed on an egalitarian pay structure. Regarding external competitiveness, Merrill Lynch is competitive with the market in base and benefits, and is a market leader in bonus and stock. Microsoft has made changes in its approach to external competitiveness. It shifted its strategy to increase base pay and bonuses to the 65th percentile from the 45th percentile, of competitors' pay, while retaining a strong emphasis on options. It recently replaced stock options with stock awards based on individual performance.
   After students have discussed the differences and similarities between Microsoft and Merrill Lynch, they can apply this framework to their school or the company they selected.

2. **Contrast the essential differences between the best-fit and best-practices perspectives.**

The best-fit strategic approach proposes that pay programs, in combination with other HR programs, should be based on the unique characteristics of the company, its employees, and its external environment. Thus, if the pay system reflects the organization's strategy and values, is responsive to employees and union relationships, and is globally competitive, the company is more likely to achieve competitive advantage. The company's compensation strategy should support the achievement of the company's mission, vision, objectives, and strategies—the better the fit, the greater the competitive advantage.
The best-practices approach suggests that certain pay practices and programs are superior, regardless of the organization's internal or external conditions; best practices are not necessarily linked to the organization's strategy. These practices have been proven in certain companies and efforts should be spent on disseminating them throughout the workplace. Thus, adopting best-pay practices allows an employer to gain preferential access to superior HR talent. This talent, in turn, influences the strategy the organization adopts and will be a source of competitive advantage.

3. **Reread Exhibit 2.7. Discuss how those values might be reflected in a compensation system. Are these values consistent with "Let the market decide"?**

Medtronic's statement (Exhibit 2.7) lauds stability, so its likely emphasis would be placed on internal alignment issues. However, because the company depends heavily on research and development efforts to produce "the greatest possible reliability and quality in our products," the internal structure would need enough flexibility to stimulate creativity and innovation. The culture of the company portrays a very nurturing environment that would offer substantial relational returns from work. External competitiveness and market issues may be dealt with through employees "sharing in the company's success."

4. **Three tests for any source of competitive advantage are align, differentiate, and add value. Discuss whether these tests are difficult to pass. Can compensation really be a source of competitive advantage?**

Alignment of a pay strategy involves three aspects: (1) aligned with the business strategy; (2) aligned externally with the economic and sociopolitical conditions; and (3) aligned internally with the overall HR system. Alignment is probably the easiest test to pass.
Differentiation of a pay strategy involves having a different strategy compared to one's competitors. Advocates of the strategic approach propose that sustained advantage comes from how the pay system is managed. While it may be easy to imitate any single pay practice of a competitor, the strategic perspective implies it is the way pay practices fit together and fit the organization's strategy that is hard to copy. Simply copying competitors, blindly benchmarking and following best practices amounts to trying to stay in the race, not winning it.

A compensation system adds value if it allows the company to attract, retain, and motivate the kinds of employee behaviors that will help the company achieve its goals. It must do so in a cost-effective manner, so the company is not at a competitive disadvantage in marketing its goods and services. Since compensation is often a company's largest controllable expense, the challenge is determining how to calculate the return on investment (ROI) of different forms of pay. Trying to measure ROI for a compensation strategy implies that people are "human capital," a view that some people find dehumanizing. Viewing pay as an investment with measurable returns diminishes the importance of treating employees fairly. Of all three tests, this one is the most difficult to "pass."

The ability of compensation to be a source of competitive advantage is an issue for debate. As indicated above, several types of single pay practices are easily imitated (i.e. amount of base pay, benefits, stock options, etc.). However, as the strategic perspective implies, it is the way pay practices fit together, fit the organization's strategy, and are managed that may result in a sustained competitive advantage.

5. **Set up a debate over the following proposition: Nonfinancial returns (great place to work, opportunities to learn, job security, and flexible work schedules) are more important (i.e., best practice) than pay.**

Arguments against the topic:

- Money or pay is the fundamental motivator or work performance.
- The basic performance of the pay-for-performance and ESOPs systems were devised to motivate employees using pay. The success of these systems shows that pay takes higher precedence over the nonfinancial returns in motivating employees to work.
- There has been a shift in ideology with higher pay being the only incentive for ones' career.
- The trend of switching employers for a higher pay has increased in recent times. This is one of the major reasons for high attrition.
- Evidence suggests that the trend of doing an MBA, especially an Executive MBA, is attributed to higher financial returns from MBA jobs.
- In recent times, highly paid executives who worked in companies that received the government's financial support, via TARP, are shifting to so-called "boutique" firms (which do not come under the umbrella of TARP and thus not covered by TARP regulations on compensation) just to avoid higher taxes.

Arguments in favor of the topic:

- Pay, when used as the *only* motivating factor, prompts employees to put in just the minimum performance that is required to get the next raise or promotion.
- Evidence supports affective and cognitive aspects such as job satisfaction, motivation and innovation as being furthered by non-financial returns attributable to one's job.
- Emotional, mental, and physical well-being have taken on a vast role in career decision

making and is supported by major companies around the world that strive to provide necessary facilities that move beyond the scope of pay.
- Commitment towards one's job, also supported by research evidence, seems to decrease without elements of relational returns. Relational returns is a value-add that employees look toward when pay-for-performance or other accepted forms of pay are on par with industry standards.
- Essentially, the quality of work-life balance is stressed upon by employees seeking to further their career in a fulfilling manner.

The conclusion to this debate would be a neutral stand where pay and nonfinancial returns are equally important to motivate people to work, although in slightly different propositions depending on the individual and the working conditions.
Research on motivating factors has revealed mixed results. However, employees are motivated to work based on pay. But they put in extraordinary efforts only when they are provided nonfinancial returns as well. In short, pay makes employees 'work' and nonfinancial returns make them 'perform.'