CHAPTER 1

Strategic Compensation: A Component of Human Resource Systems

## **Learning Objectives**

* 1. Define strategic compensation.
  2. Summarize the role of compensation as a strategic business partner.
  3. Explain strategic compensation decisions.
  4. Identify and discuss the building blocks and structural elements of strategic compensation systems.
  5. Describe the fit of the compensation function in organizations.
  6. Identify the stakeholders of the compensation function and summarize their stakes in the work compensation professionals perform.

Outline

I. Overview

II. Defining Strategic Compensation

III. Compensation as a Strategic Business Partner

IV. Strategic Compensation Decisions

V. Building Blocks and Structure of Strategic Compensation Systems

VI. Fitting the Compensation Function in an Organization’s Structure

VII. Stakeholders of the Compensation System

VIII. Key Terms

IX. Discussion Questions and Suggested Answers

X. End of Chapter Case; Instructor Notes, and Questions and Suggested Student Responses

XI. Crunch the Numbers! Questions and Suggested Student Responses

XII. Assisted-Graded Questions

XIII. Additional Case from the MyManagementLab website; Instructor Notes and Questions and Suggested Student Responses

Lecture Outline

I. Overview

A. Manpower planning

1. Predecessor to contemporary human resource management, focus was on effective deployment of employees

2. Goal was to achieve maximum productivity per employee

B. Personnel management

1. Evolved due to government regulations concerning:

a. Payroll taxes

b. Minimum wage laws

c. Antidiscrimination laws

2. Competitive advantage

a. Since 1980’s recognition that employees can contribute to competitive advantage

b. Competitive advantage describes a company’s success when the company acquires or develops capabilities that facilitate outperforming the competition

c. HR becomes a strategic function

II. Defining Strategic Compensation

A. What Is Compensation?

1. Intrinsic and extrinsic rewards employees receive for performing their jobs

a. Intrinsic compensation: reflects employees’ psychological mindsets that result from performing their jobs

b. Extrinsic compensation: includes both monetary and nonmonetary rewards for:

i. Obtaining certain job performance levels

ii. Acquiring new skills and knowledge

2. Monetary compensation represents core compensation

3. Nonmonetary rewards (also known as employee benefits) include:

a. Protection programs (e.g., medical insurance)

b. Paid time off (e.g., vacations)

c. Services (e.g., daycare assistance)

B. What is Strategic Compensation?

1. Competitive business strategy refers to the planned use of company resources

2. Human resource strategies specify the use of multiple HR practices to reinforce competitive business strategy.

3. Strategic compensation refers to the design and implementation of compensation systems to reinforce the objectives of both HR strategies and competitive business strategies

**III. Compensation as a Strategic Business Partner**

1. HR and compensation professionals today need to think like the chief executive officer (CEO) to become a strategic partner in achieving organizational plans and results
2. Compensation professionals can give the CEO and CFO an understanding of the roles employees play in the organizations to expand or shrink shareholder value
3. How HR functions serve as strategic business partner
   1. Capital refers to factors that enable companies to generate income, raise stock prices, bring economic value, strong brand identity, and reputation
   2. Human capital, refers to sets of collective skills, knowledge, and abilities that employees can apply to create value for their employers
   3. Compensation professionals can leverage the value of human capital in a variety of ways such as a well-designed merit pay program to reinforce performance

**IV. Strategic Compensation Decisions**

1. Environmental scanning
2. Used for strategy formulation
3. Main focus is discerning threats and opportunities
4. Competitive business strategy choices
5. Lowest-cost strategy or cost leadership focuses on gaining completive advantage by being the lowest-cost producer of a product or service within the marketplace
6. Differentiation strategies develop products or services that are unique from those of their competitors
7. Compensation decisions that support the firm’s strategy
8. Compensation professionals use two broad elements to support strategic initiatives
   1. Basic building blocks
   2. Structural design elements
9. Employee roles associated with competitive strategies
   1. Compensation professionals must design and implement compensation practices that elicit strategy-consistent employee roles

**V. Building Blocks and Structure of Strategic Compensation Systems**

A. Building blocks: Core compensation and Employee Benefits

1. Core compensation

a. Base pay includes hourly pay or wage or salary

b. Is governed by Fair Labor Standards Act of 1938

c. Is set according to compensable factors such as level of skill, effort, and responsibility required to perform the job and the severity of the working conditions

i. Compensable factors are used to determine if jobs are equal under the Equal Pay Act of 1963

d. Is adjusted periodically for cost-of-living increases, differences in an employee’s job performance, and increases in an employee’s skill level or job knowledge

e. Seniority pay systems reward employees with periodic additions to base pay according to employees’ length of service in performing their jobs

i. Designed according to the human capital theory: employees will become more productive as they refine existing skills and acquire new skills and knowledge through length of service

f. Merit pay is permanent base pay increases granted because of job performance

g. Incentive pay or variable pay rewards employees for partially or completely attaining a pre-determined work objective

h. Person-focused pay or competency-based pay rewards employee for specifically learning new curricula

i. Pay-for-knowledge plans reward managerial, service, or professional workers for successfully learning specific curricula

ii. Skill-based pay is used mostly for employees who perform physical work and increases as workers master new skills

2. Employee Benefits

a. Represent nonmonetary rewards

b. Discretionary benefits include three broad categories

i. Protection programs that provide family benefits, promote health, and guard against income loss caused by factors such as unemployment, disability, or serious illness

ii. Paid time off such as vacation

iii. Services provide such enhancements as tuition reimbursement and day care assistance

c. Legally-required benefits are protection programs that attempt to promote worker safety and health and maintain family income streams

i. Social Security Act of 1935

ii. Family and Medical Leave Act of 1993

iii. Patient Protection and Affordable Care Act of 2010

B. Fundamental Compensation System Design Elements

1. Internal consistency

a. Internally consistent compensation systems clearly define the relative value of each job among all the jobs within a company

b. Is based on the principle that employees working at jobs that require greater qualifications, more responsibilities, and/or more complex job duties should be paid more

c. Is achieved using job analysis and job evaluation

i. Job analysis is a systematic process for gathering, documenting, and analyzing information in order to describe jobs

ii. Job evaluation is used to systematically recognize differences in the relative worth among a set of jobs

2. Market competitiveness

a. Market-competitive pay systems are based on results of compensation surveys

b. Compensation surveys collect and then analyze competitors compensation data

3. Recognizing Individual Contributions

a. Pay structures recognize differences in employee contributions, such as credentials, job knowledge, and job performance

b. Pay grades group jobs for pay policy application

c. Pay ranges include minimum, maximum, and midpoint pay rates

C. Alternative Pay Structure Configurations

1. Merit pay plans

2. Sales compensation plans

1. Broadband structures
2. Two-tier wage structures
3. Executive compensation
4. Contingent worker compensation
5. Expatriate compensation
6. Compensation structures in countries other than the United States

**VI. Fitting the Compensation Function in an Organization’s Structure**

A. How HR Professionals Fit into the Corporate Hierarchy

1. Line employees are workers who are directly involved in producing a company’s goods or services

2. Staff employees are workers whose job it is to support the line functions- human resource professionals are staff employees

3. HR practices include:

a. Recruitment

b. Selection

c. Performance appraisal

d. Training

e. Career development

f. Labor-management relations

g. Employment termination

h. Managing HR within the context of legislation

B. The Compensation Function

1. An executive is a top-level manager who reports directly to the corporation’s CEO or to the head of a major division

2. A generalist, who may be an executive, performs tasks in a variety of HR-related areas

3. A specialist may be an HR executive, manager, or non-manager who is typically concerned with only one of the areas of compensation practice

C. How the Compensation Function Fits into HR Departments

1. Compensation, recruitment, and selection

a. Companies can spark interest by communicating the positive features of the core compensation and employee benefits programs

b. Companies may offer inducements such as signing bonuses

2. Compensation and performance appraisal

a. Is key to effective merit pay programs

b. Employees must perceive a strong relationship between attaining performance standards and receiving pay increases

3. Compensation and training

a. Successful pay-for-knowledge plans depend upon a company’s ability to develop and implement systematic training programs

b. Companies implementing pay-for-knowledge plans typically increase the amount of classroom and on-the-job training

4. Compensation and career development

a. Employees make lateral moves across a company’s hierarchy or vertical moves up the hierarchy

b. Employees compensation changes reflect career development

5. Compensation and labor-management relations

a. Companies grant COLAs

b. Companies establish base pay on seniority pay

6. Compensation and employment termination

a. Employment terminations are either involuntary or voluntary

b. Some companies offer severance pay for involuntary terminations

c. Companies sponsor pension programs in the case of retirement

d. Companies sometimes use early retirement programs to reduce workforce size

7. Compensation and legislation

a. Laws were enacted to establish acceptable employment practices and protect employees’ rights

b. Are grouped on four main themes

i. Income continuity, safety, and work hours

ii. Pay discrimination

iii. Accommodation of disabilities and family needs

iv. Prevailing wage laws

c. Relevant laws include:

i. Fair Labor Standards Act of 1938

ii. Equal Pay Act of 1963

iii. Civil Rights Act of 1964

iv. Patient Protection and Affordable Care Acto of 2010

v. Pregnancy Discrimination Act of 1978

vi. Americans with Disabilities Act of 1990 (amended in 2008)

vii. Family and Medical Leave Act of 1993

viii.Davis–Bacon Act of 1931

**VII. Stakeholders of the Compensation System**

A. The success of HR departments depends on how they will serve various stakeholders including:

1. Employees

2. Line managers

3. Executives

4. Unions

5. U.S. government

B. Employees

1. Must educate employees on training options and connections between training and their pay

2. Must determine which objectives of discretionary benefits are most important to their particular workforce

C. Line managers

1. Use their knowledge of relevant laws to help them make sound compensation judgments

2. Advise them on establishing pay rates

E. Executives

1. Develop and manage sound compensation systems

F. Unions

1. Abide by their collective bargaining agreements

G. U.S. Government

1. Keep updated and comply with all employment legislation

2. Demonstrate that alleged discriminatory pay practices are not discriminatory

**End of the Chapter**

**VIII. Key Terms**

**Competitive advantage:** Describes a company’s success when the company acquires or develops capabilities that facilitate outperforming the competition

**Intrinsic compensation:** Reflects employees’ psychological mind-sets that result from performing their jobs

**Extrinsic compensation:** Includes both monetary and nonmonetary rewards

**Core compensation:** Monetary compensation

**Employee benefits:** Non-monetary compensation

**Competitive business strategy:** The planned use of company resources—financial capital, equipment capital, and human capital— to promote and sustain competitive advantage

**Human resources strategies:** Specify the use of multiple HR practices to reinforce competitive business strategy

**Strategic compensation:** Refers to the design and implementation of compensation systems to reinforce the objectives of both HR strategies and competitive business strategies

**Capital:** Refers to the factors that enable companies to generate income, higher company stock prices, economic value, strong positive brand identity, and reputation

**Human capital**: Refers to sets of collective skills, knowledge, and abilities that employees can apply to create value for their employers

**Cost leadership (lowest-cost strategy):** Focuses on gaining competitive advantage by being the lowest-cost producer of a product or service within the marketplace, while selling the product or service at a price advantage relative to the industry average

**Differentiation strategies:** Companies adopt this strategy when they develop products or services that are unique from those of their competitors

**Base pay:** Recurring money employees receive for doing their jobs

**Hourly pay or wage:** Base pay received for each hour worked

**Salary:** Base pay received for performing a job, regardless of the actual number of hours worked

**Compensable factors:** Skill, effort, responsibility, and working condition factors

**Cost-of-living adjustment:** Represent periodic base pay increases that are founded on changes in prices as recorded by the Consumer Price Index (CPI)

**Seniority pay:** Asystem to reward employees with periodic additions to base pay according to employees’ length of service in performing their jobs

**Human capital theory:** Employees’ knowledge and skills (human capital) add value

**Merit pay:** Program that assumes that employees’ compensation over time should be determined, at least in part, by differences in job performance as judged by supervisors or managers

**Incentive pay:** Compensation (other than base wages or salaries) that fluctuates according to employees’ attainment of some standard based on a preestablished formula, individual or group goals, or company earnings

**Variable pay:** Compensation (other than base wages or salaries) that fluctuates according to employees’ attainment of some standard based on a preestablished formula, individual or group goals, or company earnings

**Person-focused pay:** Programs that reward employees for specifically learning new curricula

**Competency-based pay:** Programs that reward employees for specifically learning new curricula

**Pay-for-knowledge:** Programs that reward managerial, service, or professional workers for successfully learning specific curricula

**Skill-based pay:** Programsthat increase workers’ pay as they master new skills

**Discretionary benefits:** Any variety of programs that provide paid time off, employee services, and protection programs that are offered on a discretionary basis

**Legally required benefits:** Particular sets of benefits the U.S. government requires employers to offer to employees

**Paid time off:** Provides employees with pay for time when they are not working (e.g., vacation)

**Services:** Provide such enhancements as tuition reimbursement and day care assistance to employees and their families

**Protection programs:** Legally required benefits that attempt to promote worker safety and health, maintain the influx of family income, and assist families in crisis

**Internally consistent compensation systems:** Clearly define the relative value of each job among all jobs within a company

**Job analysis:** A a systematic process for gathering, documenting, and analyzing information in order to describe jobs

**Job evaluation:** A processto recognize differences in the relative worth among a set of jobs and to establish pay differentials accordingly

**Market-competitive pay systems:** Compensation professionals build market-competitive compensation systems based on the results of compensation surveys

**Compensation surveys:** Collect and then analyze competitors’ compensation data

**Pay structures:** Represent pay rate differences for jobs of unequal worth and the framework for recognizing differences in employee contributions

**Pay grades:** Group jobs for pay policy application

**Pay ranges:** Include minimum, maximum, and midpoint pay rates

**Line employees:** Employees that aredirectly involved in producing companies’ goods or delivering their services

**Staff employees:** Employees that support the line functions

**Severance pay:** Companies may choose to award and amount, usually the equivalent of several months’ pay following involuntary termination

**Pension programs:** Provide income to individuals throughout their retirement

**Early retirement programs:** Contain incentives designed to encourage highly paid employees with substantial seniority to retire earlier than they had planned

**Generalist:** A human resource professional that may be an executive that performs tasks in a variety of HR-related areas

**Specialist** An HR executive, manager, or non-manager who is typically concerned with only one of the areas of compensation practice

**IX. Discussion Questions and Suggested Answers**

* 1. **Define compensation.**

Compensation represents both the intrinsic and extrinsic rewards employees receive for performing their jobs. Together, both intrinsic and extrinsic compensation describes a company’s total compensation level. Intrinsic compensation reflects an employee’s psychological mindsets that result from performing his or her job. Extrinsic compensation includes both monetary and nonmonetary rewards.

Learning Objective: 1-1. Define strategic compensation.

AACSB: Analytical thinking

* 1. **Identify two companies—one that you believe pursues a lowest-cost strategy and another that pursues a differentiation strategy. Relying on personal knowledge, company annual reports, or articles in newspapers and business periodicals, discuss these companies’ competitive strategies.**

The cost leadership or lowest-cost strategy focuses on gaining competitive advantage by being the lowest-cost producer of a product or service within the marketplace, while selling the product or service at a price advantage relative to the industry average. Ryanair is an excellent illustration of an organization that pursues a lowest-cost strategy because its management successfully reduced operating costs. At least two noteworthy decisions have contributed to Ryanair’s goals. First, Ryanair’s training and aircraft maintenance costs are lower than similar competitor’s costs because the airline uses only Boeing 737 aircraft. Ryanair enjoys substantial cost savings because it does not need to use different curricula for training flight attendants, mechanics, and pilots to learn about procedures specific to different aircraft models. Second, newer aircraft sport seats that do not recline, have seat-back pockets, or life jackets stowed under the seat. These cost less and also allow service personnel to clean aircraft more quickly, saving on labor costs. Third, Ryanair airplanes include one toilet to make room for additional passenger seats. Fourth, passengers are required to carry their luggage to the plane, reducing the cost of baggage handling.

Differentiation strategies are used to develop products or services that are unique from those of competitors. Differentiation strategies can take many forms, including design or brand image, technology, features, customer service, and price. P&G Corporation successfully pursues a differentiation strategy based on brand image and price premiums. The company offers two separate dog food lines—Iams, a super-premium line that is nutritionally well balanced for dogs and uses high quality ingredients and Eukanuba, which is an ultra-premium line that contains more chicken and vital nutrients than the Iams line, as well as additional fatty acids. Together, Iams and Eukanuba appeal to a substantial set of dog owners. The Iams Company distinguishes Eukanuba from Iams by claiming that Eukanuba is “Extraordinary Nutrition.” The Eukanuba slogan is the company’s basis for brand image.

Learning Objective: 1-3. Explain strategic compensation decisions.

AACSB: Analytical thinking

* 1. **Stakeholder expectations pose challenges for compensation professionals. At times, there may be conflict among the expectations of different stakeholders. Give two examples and explain how compensation professionals meet their expectations.**

Answer to this question can be found in the MyLab

* 1. **Are the three main elements of compensation systems—internal consistency, market competitiveness, and recognizing employee contributions—equally important, or do you believe that they differ in importance? If different, which do you believe is most important? Least important? Give your rationale.**

Answer to this question can be found in the MyLab

X. End of Chapter Case; Instructor Notes, and Questions and Suggested Student Responses

Case Name: Competitive Strategy at Sportsman Shoes

**Instructor Notes**

The human resource planning process follows the company’s strategic planning process. In this case, the company is shifting from a low-cost strategy to a differentiation strategy. Under the low-cost strategy, human resource practices focused on controlling costs and working to hire and retain workers focused on efficiency and productivity. The differentiation strategy will require some employees with a different skill set. Certain functions will need high levels of creativity and innovation. Human resource practices must shift to support these needs by attracting the right talent, and motivating the right behaviors to produce shoes for the new niche markets.

**Questions and Suggested Student Responses:**

* 1. **Following Sportsman’s shift in competitive strategy, what are some considerations for the company’s human resource management practices?**

Answer to this question can be found in the MyLab

* 1. **What kind of challenges will Sportsman face specifically in the area of compensation?**

The new hires the company will need to make will create some compensation challenges. The company will need to make compensation competitive in the market place to make sure that they are able to attract the new talent needed. However, they must also keep compensation internally consistent at the same time. The company will need to examine its entire compensation strategy (including benefits and incentive pay) to make sure it is aligned with the company’s new goals.

Learning Objective: 1-3. Explain strategic compensation decisions.

AACSB: Analytical thinking

**XI. Crunch the Numbers! Questions and Suggested Student Responses**

**Calculating the Costs of Increasing the Total Compensation Budget at Butcher Enterprises**

* 1. **On an average hourly basis, how much does Butcher Enterprises spend on wages and benefits, respectively, in dollars?**

Butcher Enterprises spends an average of $19 per hour on wages and benefits. 70% of this amount or $13.30 is allocated for wages and 30% or $5.70 for benefits.

Learning Objective: 1-4. Identify and discuss the building blocks and structural elements of strategic compensation systems.

AACSB: Analytical thinking

* 1. **How much does the company spend on wages and benefits over the course of one year for 100 office workers? Assume that each worker provides 2,080 hours of service each year.**

The number of hours for 100 workers = 100 x 2080 = 208,000. The average hourly wage of $19 x 208,000 hours = $3,952,000 is how much the company spends on wages and benefits over the course of one year.

Learning Objective: 1-4. Identify and discuss the building blocks and structural elements of strategic compensation systems.

AACSB: Analytical thinking

* 1. **How much additional money does the company need to match the market rates for this group of 100 employees?**

You must first calculate the total for wages and benefits for market rate which is $23 x 208,000 hours = $4,784,000. The difference between $4,784,000 and $3,952,000 = $832,000. Therefore, Butcher Enterprises would need to spend an additional $832,000 per year to match the market rate for this group of employees.

Learning Objective: 1-4. Identify and discuss the building blocks and structural elements of strategic compensation systems.

AACSB: Analytical thinking

**XII. Assisted-Graded Questions**

* 1. **Explain the similarities and differences between merit pay, incentive pay, and person-focused pay. Explain the role of performance appraisals in merit pay programs.**

Answer to questions can be found in the MyLab

* 1. **Discuss how compensation professionals contribute to a firm’s competitive advantage.**

Answer to questions can be found in the MyLab

* 1. **MyManagementLab Only – comprehensive writing assignment for this**

**chapter.**

**XIII.** Additional Case from the MyManagementLab Website; Instructor Notes and Questions and Suggested Student Responses

**Case Name: Is It Time to Hire a Compensation Expert?**

**Instructor Notes**

Organizations are challenged to ensure the right number of staff positions relative to line positions. As a company grows, their need for additional human resources staff will likely grow as well. Depending on the company’s goals, different types of human resources expertise may help the organization operate more effectively in order to obtain those goals. Most organizations will hire a recruiter to help acquire new talent for the organization. But, with growth, the compensation-related issues the company faces also grows. Compensation expertise can benefit a growing company by creating a pay structure and competitive benefits that allows the company to attract and retain employees to support future company growth.

**Questions and Suggested Student Responses:**

* 1. **Do you think EasySpa would benefit from hiring a compensation professional? How?**

As the organization plans continued growth, there are many benefits that a compensation professional can provide. Having compensation expertise can help support other practices such as recruitment. By designing a compensation structure that is attractive to candidates, EasySpa may be able to better recruit talent. Further, the pay structure can help hiring managers more effectively set pay rates for new hires. A compensation professional can also help design a benefits package that is both attractive and cost efficient.

Learning Objective: 1-5 Describe the fit of the compensation function in organizations.

AACSB: Analytical thinking

* 1. **How can Jay convince the CEO to hire a compensation professional?**

A compensation professional can better structure the company’s compensation by ensuring pay levels are appropriate through ensuring internal consistency in pay while keeping pay levels competitive in the marketplace. Further, a compensation professional may be able to design incentive pay programs to motivate certain groups of employees. By doing so, the company can ensure that funds spent on labor are used effectively. Further, the company may be able to realize savings in benefit costs by using an expert to design the benefits package. Finally, as a key stakeholder in the success of the company, the CEO benefits from the expertise of a compensation professional because they can ensure the company is complying with relevant employment laws.

Learning Objective: 1-5 Describe the fit of the compensation function in organizations.

AACSB: Analytical thinking