

CHAPTER ONE

THE PAY MODEL

Overview

Part One, Introducing the Pay Model and Pay Strategy, contains chapters one and two and begins by talking about what “pay” means and how paying people in different ways can influence them and, in turn, organization success. The two chapters describe the compensation policies and techniques that organizations use and the multiple objectives they hope to achieve by effectively managing these compensation decisions. The aim of Part One is to understand how compensation strategy decisions interact with the specific context of an organization (its business and human resource strategies) to influence organization success. The authors emphasize that good theory and research are fundamental to not only understanding compensation’s likely effects, but also to developing that healthy skepticism needed toward simplistic claims about what works and what does not.

Chapter one starts with a discussion on the role of poorly designed compensation plans in the current economic situation. It provides an overview of the key components of a compensation system. The definition of compensation is initially explored from the perspectives of the society, stockholders, the organization, and the external environment. Next, the various forms of pay are identified and defined. The major focus is presenting a *pay model* that provides a structure for understanding compensation systems. The three main components of the model are (1) compensation objectives, including the importance given to ethics; (2) policy decisions that guide the way objectives will be achieved; and (3) techniques that make up the pay system. The book plan is outlined at the end of chapter one. The remaining chapters examine each of the four policy decisions—internal alignment, external competitiveness, employee performance, and management—as well as the techniques, new directions, and related research.

Learning Objectives

- Compare the benefits of well-designed compensation systems to the detriments of poorly designed compensation systems.
- Define compensation from the perspectives of society, stockholders, the organization, and the external environment.
- Examine the various forms of pay including cash compensation, benefits, total earnings opportunities, and relational returns from work.
- Understand the three components of the pay model: compensation objectives, policy choices, and pay techniques.

Lecture Outline: Overview of Major Topics

- I. Compensation: Does it Matter (or, “So What?”)
- II. Compensation: Definition, Please
 - A. Society
 - B. Stockholders
 - C. Managers
 - D. Employees
 - E. Incentive and Sorting Effects of Pay on Employee Behaviors
 - F. Global Views – Vive la différence
- III. Forms of Pay
 - A. Cash Compensation: Base
 - B. Cash Compensation: Merit Increases/Merit Bonuses/COLAs
 - C. Cash Compensation: Incentives
 - D. Long-Term Incentives
 - E. Benefits: Income Protection
 - F. Benefits: Work/Life Balance
 - G. Benefits: Allowances
 - H. Total Earnings Opportunities: Present Value of a Stream of Earnings
 - I. Relational Returns from Work
- IV. A Pay Model
 - A. Compensation Objectives
 - B. Four Policy Choices
 - C. Pay Techniques
- V. Book Plan
- VI. *Caveat Emptor*—Be an Informed Consumer
 - A. Is the Research Useful?
 - B. Does the Study Separate Correlation from Causation?
 - C. Are There Alternative Explanations?
- VII. Your Turn—The Role of Labor Costs in Retail Electronics

Lecture Outline: Summary of Key Chapter Points

I. Compensation: Does It Matter (Or, “So What?”)

- The role of poorly designed compensation plans in the recent economic downturn is analyzed from different perspectives.
- Companies that failed in recent times had labor costs higher than competition without the corresponding advantages in efficiency, quality, and customer service.
 - Examples in the text include Chrysler and General Motors (GM).
- Successful companies had relatively high pay as well as higher productivity compared to competitors. The example in the text is of Nucor Steel.
- Wall Street financial services firms and banks used **incentive** plans that rewarded people for developing “innovative” new financial investment vehicles and for taking risks to earn themselves and their firms a lot of money.
- When the markets discovered that many such risks had gone bad, the firms either had to file for bankruptcy or wait for other companies to take them over.
- Congress and the President thought greater expertise in the design and execution of compensation plans would have controlled excessive risk-taking and prevented other problematic behaviors while promoting a positive culture.
- The resulting legislation was the Troubled Asset Relief Program (TARP), which included restrictions on executive pay and discouraged executives from taking “unnecessary and excessive risks.”
- How people are paid affects their behavior at work, which affects an organization’s success.
 - For most employers, compensation is a major part of total cost, and often it is the single largest part of operating costs.
- Well-designed compensation systems can help an organization achieve and sustain competitive advantage.
 - Poorly designed compensation systems can play a major role in undermining organization success.

II. Compensation: Definition, Please

- People’s view of compensation differs depending on whether they look at compensation from the perspective of a member of society, a stockholder, a manager, or an employee.
 - Thus, the text analyzes the definition and importance of compensation from several different perspectives.

A. Society

- Some people see pay as a measure of justice.

- For example: comparing earnings of women with those of men highlights potential pay inequities.
- In 2016, among full-time workers in the United States, women earned 82% of what men earned, up from 62% in 1979.
- If women had the same education, experience, and union coverage as men and worked in the same industries and occupations, the ratio could increase as high as 90%, still leaving a sizable gap.
- Society has taken interest in such earning differentials by introducing laws and regulation aimed at eliminating the role of discrimination in causing them.
- Benefits given as a part of total compensation may also be seen as a reflection of societal equity or justice.
- Civilian employers spend about 46 cents for benefits on top of every dollar paid for **wages** and **salaries**. For state and local government employers, it is even higher at 60 cents.
- Job losses or gains in a country over time are partly a function of relative labor costs (and productivity) across countries.
- Exhibit 1.1 reveals that the hourly compensation (wages plus benefits) for Mexican manufacturing work (\$3.91) are about 10% of those paid in the U.S. (\$36.34).
 - However, the value of what is produced also needs to be considered. Mexican worker productivity is 34% of the U.S. level.
- Some consumers know that pay increases often lead to price increases.
 - They do not believe that higher labor costs benefit them.
 - Other consumers lobby for higher wages.

B. Stockholders

- Stockholders differ on their views of whether employees should be given stock options or not.
 - Supporters of this thought believe that it creates a sense of ownership that will improve performance and eventually increase stockholder wealth.
 - Opponents argue that granting employees too much ownership dilutes stockholder wealth.
- Stockholders have a particular interest in executive pay.
 - To the degree that the interests of executives are aligned with those of shareholders (e.g., by paying executives on the basis of company performance measures such as shareholder return), the hope is that company performance will be higher.
- In the absence of a linkage between executive pay and company performance, concerns arise that the executives can somehow use their influence to obtain high pay without necessarily performing well.

- Exhibit 1.2 provides data on CEO compensation.
 - Note the large total annual compensation of \$11.5 million and that the bulk of compensation is connected to shareholder return or short-term performance measures.
 - As such, do not expect changes in CEO wealth and shareholder wealth to be aligned.
 - More on this topic in Chapter 14.
- Shareholders can influence executive compensation decisions through shareholder proposals and election of directors in proxy votes.
- In addition, the Dodd-Frank Wall Street Reform and Consumer Protection Act on 2010 has a provision of “say on pay,” requiring public companies to submit their executive compensation plan to a nonbinding vote by shareholders.

C. Managers

- Managers view compensation as influencing their success in two ways.
 - First, compensation is a major expense that needs managing.
 - Competitive pressures force managers to consider the affordability of compensation decisions since labor costs can account for more than 50% of total costs. Some industries are even higher.
 - Labor costs as a percent of total costs vary among individual firms.
 - The neighborhood grocery, with labor costs between 15-18%, have been run out of business by supermarkets with lower labor costs of 9-12%.
 - Warehouse club stores enjoy even lower cost of labor at 4-6%.
 - Now that Amazon has entered grocery sales it will cause further cost reductions and disruption.
 - Exhibit 1.3 compares the hourly pay rate for retail workers at Costco to that at Walmart and Sam’s Club.
 - Costco chose to pay higher wages to attract and retain a higher quality workforce.
 - As Exhibit 1.3 shows, Costco is quite successful in terms of employee retention, customer satisfaction, and the efficiency with which it generates sales.
 - Second, it is a major determinant of employee attitudes and behaviors (and thus, organization performance).
 - A manager can use pay to influence employee behaviors and improve the organization’s performance.
 - High pay, if it brings high returns, is one strategy.
 - Pay affects quality of employee’s work, their attitude toward customers, their willingness to be flexible, learn new skills, or suggest innovations.

- Pay also may drive employees to unions or even legal action.

D. Employees

- For most employees, pay is a major source of financial security.
- Employees may view compensation as:
 - a *return in an exchange* between their employer and themselves,
 - as an **entitlement** for being an employee of the company,
 - as an incentive to take/stay in a job and invest in performing well, or
 - as a reward for having done so.
- Compensation can be all of these things.

E. Incentive and Sorting Effects of Pay on Employee Behaviors

- Pay influences employee **motivation** and behavior in two ways:
 - Pay can affect the motivational intensity, direction, and persistence of current employees.
 - Motivation, together with employee **ability** and work/organizational design, determines employee behaviors such as performance.
 - This effect of pay is known as **incentive effect**, the degree to which pay influences individual and aggregate motivation among the employees we have at any point in time.
 - Pay can also have an indirect, but important, influence via a **sorting effect** on the composition of the workforce.
 - That is, different types of pay strategies may cause different types of people to apply to and stay with an organization.
 - It is not only how much, but *how* an organization pays that can result in a sorting effect.
- People differ regarding which type of pay arrangement they prefer.
 - The question for organizations is simply this: Are you using the pay policy that will attract and retain the types of employees you want?
 - Focusing only on the incentive effects of pay can miss the other major mechanism (sorting) by which pay decisions influence employee behaviors.
 - The pay model that comes later in this chapter includes compensation policies and the **objectives** (efficiency, fairness, compliance) these are meant to influence.
 - Compensation policies work through employee incentive and sorting effects to either achieve or not achieve the company's objectives.

F. Global Views—*Vive la différence*

- In English, compensation means something that counterbalances, offsets, or

makes up for something else.

- In China, the traditional characters for the word “compensation” are based on the symbols for logs and water; meaning that compensation provides the necessities in life.
 - In the recent past, compensation was viewed as an entitlement.
 - Today, a new word, *dai yu*, is used; it refers to how one is treated with respect to wages, benefits, training opportunities, and so on.
 - The contemporary meaning of compensation includes returns as well as entitlement.
- “Compensation” in Japanese is *kyuyo* which means “giving something.”
 - Traditionally, compensation was viewed as something given by one’s superior.
 - Today the word *hou-syu*, which means “reward,” is used; it has no association with notions of superiors.
 - *Teate*, which means “taking caring of something,” is regarded as compensation that takes care of employees’ financial needs.
 - It includes the many allowances (family, housing, and commuting allowances) still used in many Japanese companies.
- Contrasting ideas about compensation—multiple views and multiple meanings—add richness to the topic.
 - To minimize confusion, the following definition of “compensation” or “pay” is provided:

Definition: Compensation refers to all forms of financial returns and tangible services and benefits employees receive as part of an employment relationship.

III. Forms of Pay

- Exhibit 1.4 shows the variety of returns people receive from work. They are categorized as:
 - **Total compensation**—these returns are transactional in nature and include pay received directly as cash (e.g., base, merit, incentives, cost-of-living adjustments) and indirectly as benefits (e.g., pensions, medical insurance, programs to help balance work and life demands).
 - **Relational returns**—these are psychological and include recognition and status, employment security, learning opportunities, challenging work and so on.

A. Cash Compensation: Base

- *Base wage* is the cash compensation an employer pays for work performed; it reflects value of work or skills and generally ignores differences attributable to individual employees.

- In the U.S., **salary** refers to pay given to employees who are **exempt** from regulations of the Fair Labor Standards Act and are exempt from overtime pay.
 - *Nonexempts* have their pay calculated on an hourly wage. Salary is calculated at an annual or monthly rate.
- Rather than dividing employees into separate categories of salaried and wage earners, some organizations (IBM and Walmart) believe an “all-salaried” workforce reinforces an organizational **culture** where all employees are part of the same team.

B. Cash Compensation: Merit Increases/Merit Bonuses/COLAs

- A *cost of living adjustment (COLA)* to base wages may be based on changes in what other employers are paying for the same work, changes in living costs, or changes in experience or skill.
- *Merit increases* are given as increments to the base pay and are based on performance.
- Companies increasingly use *merit bonuses*.
 - These are based on performance rating but are paid in the form of a lump sum rather than becoming (a permanent) part of the base salary.

C. Cash Compensation: Incentives

- *Incentives* also tie pay increases to performance. However, incentives differ from merit adjustments:
 - An incentive program relies on an objective measure of performance (e.g. sales) usually in a formula-based way, whereas a merit increase program typically relies on a subjective rating of performance.
 - They do not increase base wage and must be re-earned each pay period.
 - The potential size of incentive payment will be known (formula) beforehand.
 - Whereas merit pay programs evaluate past performance of an individual and then decide on the size of the increase, what must happen in order to receive the incentive payment is called out very specifically ahead of time.
 - For example, a Toyota salesperson knows the **commission** on a Land Cruiser versus a Prius prior to making the sale.
 - While both merit pay and incentives try to influence performance, incentives explicitly try to influence future behavior whereas merit recognizes (rewards) past behavior, which is hoped to influence future behavior.
 - The incentive-reward distinction is a matter of timing.
- Incentives can be tied to the performance of an individual employee, a team of employees, a total business unit, or some combination of individual, team, and unit.
- The performance objective may be expense reduction, volume increases, customer satisfaction, revenue growth, return on investments, and increase in stock value—the possibilities are endless.

- Because incentives are one-time payment, they do not permanently increase labor costs.
 - When performance declines, incentive pay automatically declines, too.
 - Consequently, incentives (and sometimes merit bonuses also) are frequently referred to as **variable pay**.

D. Long-Term Incentives

- Incentives may be short- or long-term.
- Long-term incentives are intended to focus employee efforts on multiyear results and are in the form of stock ownership or options to buy stock at a fixed price.
- The belief is that employees with a financial stake in the organization will focus on long-term financial objectives: return on investment, market share, return on net assets, and the like.

E. Benefits: Income Protection

- Exhibit 1.4 showed that benefits, including income protection, work/life services, and allowances, are also part of total compensation.
- Some income protection programs are legally required in the United States; employers must pay into a fund that provides income replacement for workers who become disabled or unemployed.
- Employers make half the contributions to Social Security.
- Medical insurance, retirement programs, life insurance, and savings plans are common benefits. They help protect employees from financial risks inherent in daily life.

F. Benefits: Work/Life Balance

- Programs that help employees integrate their work and life responsibilities include:
 - time away from work (vacations, jury duty);
 - access to services to meet specific needs (drug counseling, financial planning);
 - and
 - flexible work arrangements (telecommuting, nontraditional schedules, nonpaid time off).

G. Benefits: Allowances

- Allowances often grow out of whatever is in short supply; for example, housing and transportation allowances are frequently part of the pay package in China.

H. Total Earnings Opportunities: Present Value of a Stream of Earnings

- Up to this point compensation has been treated as something paid or received at a moment in time.
 - But a firm's compensation decisions have a temporal effect.

- A present-value perspective shifts the comparison of today's initial offers to consideration of future bonuses, merit increases, and promotions.

I. Relational Returns from Work

- Non-financial returns from work have a substantial effect on employees' behavior.
- Exhibit 1.3 includes such relational returns from work as recognition and status, employment security, challenging work, and opportunities to learn.
 - Other forms of relational return might include personal satisfaction from successfully facing new challenges, teaming with great co-workers, and receiving new uniforms.
- Such factors are part of the total return, which is a broader umbrella than total compensation.

The Organization as a Network of Returns

- It is useful to view an organization as a network of returns created by all the different forms of pay, including total compensation and relational returns.
- The challenge is to design this network so that it helps the organization to succeed.

IV. A Pay Model

- Exhibit 1.5 shows a pay model.
 - This pay model serves as both a framework for examining current pay systems and a guide for most of this textbook.
 - It contains three basic building blocks:
 1. the compensation objectives,
 2. the policies that form the foundation of the compensation system, and
 3. the techniques that make up the compensation system.

A. Compensation Objectives

- Pay systems are designed to achieve certain objectives.
 - The basic objectives, shown at the right side of the model, include efficiency, fairness, ethics, and compliance with laws and regulations.
 - *Efficiency*—can be stated more specifically: (1) improving performance, increasing quality, delighting customers and stockholders and (2) controlling labor costs.
 - Compensation objectives at Medtronic and Whole Foods are contrasted in Exhibit 1.6.
 - Medtronic, pacemaker pioneer, emphasizes performance, business success, minimized fixed costs, and attracting and energizing top talent.

- Whole Foods first compensation objective is committed to increasing shareholder value.
- *Fairness*— is a fundamental objective of pay systems.
 - It attempts to ensure fair treatment for all the employees, by recognizing both employee contributions, and employee needs.
 - *Procedural fairness* refers to the process used to make pay decisions.
- *Compliance with laws and regulations*—**compliance** as a pay objective means conforming to various federal and state compensation laws and regulations.
- *Ethics* – means the organization cares about how its results are achieved.
 - Exhibit 1.7 shows one company's code of conduct.
 - Because it is so important, it is inevitable that managing pay sometimes creates ethical dilemmas.
 - Some compensation professionals and consultants remain silent during ethical misconduct and outright malfeasance.
 - Pay objectives guide the design of the pay system and serve as the standards for judging the success of the pay system.

B. Four Policy Choices

- Every employer must address the policy decisions shown on the left side of the pay model: (1) internal alignment, (2) external competitiveness, (3) employee contributions, and (4) management of the pay system.
- These are the foundations on which pay systems are built and they serve as guidelines for managing pay in ways that accomplish the system's objectives.

Internal Alignment

- **Internal alignment** refers to comparisons among jobs or skill levels inside a single organization.
- Jobs and people's skills are compared in terms of their relative contributions to the organization's business objectives.
- Internal alignment pertains to the pay rates both for employees doing equal work and for those doing dissimilar work.
 - Whole Foods tries to manage differences with a salary cap that limits the **total cash** compensation of any executive to 19 times the average cash compensation of all full-time employees.
 - However, the cap originally started at 8 times the average and it does not include stock options.
- Pay relationships within the organization affect all three compensation objectives:
 - By motivating employees to choose increased training and greater

responsibility in dealing with customers, internal pay relationships indirectly affect the capabilities of the workforce and hence the efficiency of the entire organization.

- Fairness is affected through employees' comparisons of their pay to the pay of others in the organization.
- Compliance is affected by the basis used to make internal comparisons.

External Competitiveness

- **External competitiveness** refers to pay comparisons with competitors.
- Many organizations claim their pay systems are market-driven, that is, based almost exclusively on what competitors pay.
 - “Market driven” gets translated into practice in different ways.
- External competitiveness decisions—both how much and what forms—have a twofold effect on objectives:
 1. To ensure that the pay is sufficient to attract and retain employees—if employees do not perceive their pay as competitive in comparison to what other organizations are offering for similar work, they may be more likely to leave.
 2. To control labor costs so that the organization's prices of products or services can remain competitive in a global economy.

Employee Contributions

- How much emphasis should there be on paying for performance?
 - Should one programmer be paid differently from another if one has better performance and/or greater seniority?
 - Or should there be a **flat rate** for programmers?
 - Should the company share any profits with employees?
 - Share with all employees, part-time as well as full-time?
- Emphasis placed on **employee contributions** (or nature of **pay mix**) is a key policy decision since it directly affects employees' attitudes and work behaviors.
- Performance-based pay affects fairness in that employees need to understand the basis for judging performance in order to believe that their pay is fair.
- Some companies combine base pay and **team incentives** to offer higher pay if team performance warrants.
- The external competitiveness and employee contribution decisions should be made jointly.
 - Clearly, an above-market compensation level is most effective and sustainable when it exists together with above-market employee contributions to productivity, quality, customer service, or other important

strategic objectives.

Management

- Management means ensuring that the *right people* get the *right pay* for achieving the *right objectives* in the *right way*.
- The ground under compensation management has shifted.
 - The traditional focus on how to administer various techniques is long gone, replaced by more strategic thinking—managing pay as part of the business.

C. Pay Techniques

- The remaining portion of the pay model in Exhibit 1.5 shows the techniques that make up the pay system.
 - The techniques are discussed throughout this book.
- Techniques tie the four basic policies to the pay objectives.
- Uncounted variations in **pay techniques** exist.

V. Book Plan

- The focus of this book is on the design and management of compensation systems.
- **Part One, Chapters 1 – 2**, introduces the pay model which provides the structure for much of this book.
 - Chapter 2 discusses how to formulate and execute a compensation strategy.
- The pay model plays a central role in formulating and implementing an organization's pay strategy.
 - The model identifies four basic policy choices that are at the core of the pay strategy.
- **Part Two, Chapters 3 – 6**, focuses on *internal alignment* and examines pay relationships within a single organization.
- **Part Three, Chapters 7 – 8**, examines *external competitiveness* – the pay relationships among competing organizations – and analyzes the influence of market-driven forces.
- **Part Four, Chapters 9 – 11**, focuses on *employee contributions*, the third building block in the model, examining issues related to how much to pay each employee, how much and how often should an employee's pay be increased and on what basis, etc.
- **Part Five, Chapters 12 – 13**, covers employee services and benefits.
- **Part Six, Chapters 14 – 16**, covers systems tailored for special groups (sales representatives, executives, contract workers, and unions) and provides more detail on global compensation systems.
- **Part Seven, Chapters 17 – 18**, discusses critical issues related to *managing the compensation system*, including the government's role in compensation as well as

understanding, communicating, budgeting, and evaluating the results of managing a compensation system.

- Even though the book is divided into sections that reflect the pay model, pay decisions are not discrete. All of them are interrelated.
- The intent throughout the book is to examine alternative approaches.
 - There is rarely a single correct approach, alternative approaches exist or can be designed.

VI. *Caveat Emptor* – Be an Informed Consumer

- Students and future managers need to be informed consumers of compensation research.
 - They must be able to understand the state of knowledge—what is and isn't known.
 - It pays to read research.
 - Some studies are irrelevant and poorly performed, but not reading research literature might turn one into a prey for the latest business self-help fad.
- A consumer's guide, that includes three questions, is provided to evaluate research studies.
 - **Is the Research Useful?**
 - How useful are the variables in the study?
 - How well are they measured?
 - Does the research measure anything useful?
 - **Does the Study Separate Correlation From Causation?**
 - Once we are confident that the variables are useful and accurately measured, we must be sure that they are actually related.
 - Most often this is addressed through the use of statistical analysis.
 - The **correlation coefficient** is a common measure of association and indicates how changes in one variable are related to changes in another.
 - Many research studies use a statistical analysis known as *regression analysis*.
 - One output from a regression analysis is the R^2 . The R^2 is a squared correlation that tells us what percentage of the variation is accounted for by the variables we are using to predict or explain.
 - For example, just because a manufacturing plant initiates a new incentive plan and the facility's performance improves, we cannot conclude that the incentive plan caused the improved performance.
 - Perhaps new technology, **reengineering**, improved marketing, or the general expansion of the local economy underlies the results. The two changes are associated or related, but causation is a tough link to make.
 - **Are There Alternative Explanations?**
 - The best way to establish causation is to account for competing explanations,

- either statistically or through control groups.
- The point is alternative explanations often exist. And if they do, they need to be accounted for to establish causality.
 - It is very difficult to disentangle the effects of pay plans to clearly establish causality. However, it is possible to look at the overall pattern of evidence to make judgments about the effects of pay.

VII. Your Turn: The Role of Labor Costs in Retail Electronics

Summary of Case

The case discusses Circuit City's decision in 1997, to replace some of its highest-paid employees with lower-paid workers. Some commentators attributed the loss it suffered in the following quarter to this decision. The company was forced to liquidate later. The case also talks about Best Buy, who started aggressively cutting down costs by demoting employees, closing down its stores and eliminating corporate job positions. It faces slower sales of expensive items and increased competition from Amazon, Walmart and Target. Students are expected to analyze the possible impact of these moves on the in-store customer experience and the effect on the company's performance.

Learning Objective

Understand the impact of the change in Circuit City and Best Buy's compensation strategy on the companies' performance.

Discussion of Case Issues

Evaluate whether the replacement of highly paid workers with lower-paid workers did or did not cause Circuit City to perform so poorly. Will Best Buy face the same fate as Circuit City because of its cost cutting measures and low sales of expensive items? How confident are you in your evaluation? Why? What other data or information would be helpful in assessing Circuit City change in compensation strategy.

Teaching Guidelines

Use this case to stimulate a discussion on restructuring and analyze the impact of replacement of highly paid workers with lower-paid workers on the performance of Circuit City and the effect the cost cutting measures taken by Best Buy on its sales and competitive edge.

Student opinion on this topic may vary. While some students may favor the argument that the replacement of workers resulted in poor performance of the company, some may take a neutral stand and believe that the cause and effect relationship between the two variables can be proved only if additional data is provided. The following inputs can be considered to guide

the discussion.

Exhibit 1.8: Data on stock prices and customer satisfaction for Circuit City, Best Buy, and two other competitors, Amazon and Walmart.

- In the case of Circuit City, the customer service index had dropped in 2007, when the layoff announcement was made. On the other hand, Best Buy's customer satisfaction index hit a high in the same year.
- If you plot a graph, it will show a dip in the stock price of Circuit City during the periods of 2001 and 2003. Further research shows that the company had undergone similar restructuring in 2003, when it announced that 3,900 commissioned sales staff were being replaced with less expensive new employees (Source: *The Wall Street Journal*, February 6, 2003).

Discussion of Case Questions

1. **Thinking back to our discussion in the chapter section, Caveat Emptor—Be An Informed Consumer, evaluate whether the replacement of highly paid workers with lower-paid workers did or did not cause Circuit City to perform so poorly. How confident are you in your evaluation? Why?**

Student answers will vary. There are several reasons why Circuit City went bankrupt. Though the replacement of highly paid workers with lower paid workers was one of the reasons, it might not have been the main cause of the consumer-electronics retailer's downfall. It all started with the sales declining at Circuit City, as it started losing its market share to Minnesota based specialty electronics retailer Best Buy, the world's largest retailer Walmart, discount club stores like Costco and online retailers. Slow sales led to suppliers who cut off credit and demanded cash up front for supplies. This situation coupled with the economic downturn led Circuit City to try and negotiate sale of the retail chain, but the effort was futile. In an effort to cut costs Circuit City started firing higher paid workers and opening smaller stores. When all these measures did not help, Circuit City filed for bankruptcy protection under Chapter 11. On further study it seems the retail giant could have saved its position by focusing on unique selling proposition (USP) of its competitors. Greater variety of inventory (Best Buy), cheaper prices (Walmart and Costco) would have helped Circuit City to sustain its position of the market leader.

Sources:

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aMuM9XCHkNeo>
http://www.cbsnews.com/8301-505125_162-28241493/eight-reasons-why-circuit-city-went-bankrupt/

2. **How is Best Buy doing? Did its cuts to labor costs work?**

Answer: Best Buy's stock price has rebounded dramatically. Its cuts to labor costs has probably contributed to this improvement. However, there are likely many other factors at play besides compensation and labor costs. For example, perhaps Best Buy is doing a better job of meeting customer preferences than in the past. In this vein, ask students to compare the Best Buy website with those of Amazon and Walmart. Which websites do the students like best?

3. Why are Walmart and Amazon doing better than Best Buy (and Circuit City)? Do they have high pay?

Each of the three has their own Unique Selling Propositions (USP).

Walmart is one of the most well renowned global retail giant brands. Walmart has a large customer base and the scale gives it the ability to negotiate sharp prices from its vendors, which in turn results in substantial savings for its customers.

Amazon is a trusted brand providing online shopping experiences for customers. Amazon is positioned as a global online market place which facilitates shopping through a customized user shopping experience.

Best Buy has a customer centric style. They target the young population and corporate level individuals. Best Buy has a youthful and well informed sales force, which can help customers make informed purchase decisions.

The reason the other two are giving stiff competition to Best Buy is because of their ability to offer low prices to the customers. However, Best Buy's USP lies in its employees, if they start cutting costs and laying off their employees, it will take the edge off their business.

Entry level positions for Walmart start at \$9/hour for cashiers and sales associates. Amazon pays \$13/hour for entry level warehouse associates. Best Buy pays \$10/hour for sales associates and \$11/hour for sales consultants. According to a PayScale survey comparing the companies on the Fortune 500 list to see how median employee tenure varies, Amazon is next to dead-last in median tenure length with one year. Best Buy does a bit better with median tenure length of 2.6 years. Walmart actually has the longest median employee tenure length at 3.3 years.

Sources:

<https://www.mbaskool.com/>

<https://www.glassdoor.com/index.htm>

<https://www.payscale.com/data-packages/employee-loyalty/full-list>

4. Are there larger problems in the competitive landscape for Best Buy that cannot be solved by compensation strategy changes alone? When customers look to buy electronics, what options do they have other than Best Buy and why would they choose these options over Best Buy? Where do customers “test drive” the product and where do they buy it? Can compensation changes address these challenges? Explain.

Best Buy faces very strong competition from Walmart, as the latter has a large customer base and it sells everything from groceries, to apparels and electronics. Also Walmart offers a wide range of products at lower prices. This is possible for Walmart to achieve because of its scale that allows it to negotiate the best prices with the suppliers and dealers. So when customers buy electronics they might go to a Best Buy store, where the sales force can help answer their questions related to the product and educate them about the features to look for. These customers with the knowledge in hand might head for a Walmart and buy the selected product at a cheaper price. However, this is not a common thing to happen and can be resolved. Best Buy can appoint a highly skilled workforce, who can not only educate the customers about the products, but also create good customer relationship, which will ensure customer loyalty and make sure that potential customers become actual customers.

Source:

<http://knowledge.wharton.upenn.edu/article.cfm?articleid=2191>

5. Is Best Buy focusing too much or too little on cost reduction? Explain.

Answers will vary depending on student's attitude. If customer satisfaction is the determining factor, Best Buy is doing the reductions correctly, customer satisfaction has not gone down, but gone up slightly and holding. While stock price did dip slightly, it is now at an all-time high.

6. If you had answered these questions about Best Buy in 2013 (when its stock price was at 13), what would you have expected to happen to Best Buy? Are you surprised by their performance since 2013? What lesson, if any, do you take away from their reversal of fortune?

Answer: One presumes that as of 2013, many did not expect Best Buy survive and that it would follow the same path as Circuit City. Might ask students to search for newspaper articles or investment analyst opinions on Best Buy from the 2013 era to see what conventional wisdom on Best Buy's prospects were back then. One lesson is that even companies that seems similar (e.g., Best Buy and Circuit City) can have different levels of success, even when facing the same industry headwinds. Compensating people in a way that supports attraction, motivation, and retention of top talent, while controlling costs is part of the recipe for success. However, that compensation system has to also focus employees on how to identify and respond to evolving customer preferences over time.

Answers to Review Questions

1. How do differing perspectives affect our views of compensation?

From a societal perspective, compensation may be viewed as:

- a measure of the inherent equity and justice in a society (examine the wages of similarly situated men versus women, blacks versus whites, etc.).
- a cause of tax increases (public employee wages) or cost-push inflation (increased wages cause higher production costs, which may be passed on as price increases for goods and services).
- a reason for U.S. difficulties in competing in international markets.

From a stockholder perspective, compensation may be viewed as:

- a mechanism to increase stockholders' wealth.
- a key method to link executive pays to company performance.

From a managerial perspective, compensation may be viewed as:

- a major expense to be managed.
- a means to influence employee work attitudes and behavior, which affect productivity.

From an employee perspective, compensation may be viewed as:

- a return for services rendered.
- a reward for meritorious performance.
- an indicator of the worth of an individual's skills or training.
- a major determinant of economic and social well-being.

From a global perspective, compensation may be used to convey more contemporary meanings:

- Countries like China and Japan have replaced traditional words associated with pay to words that capture the more contemporary and comprehensive meanings associated with pay. These include 'dai yu,' in Chinese, which refers to how the employee is being treated, and 'teate', in Japanese, which means taking care of something.

2. What is your definition of compensation? Which meaning of compensation seems most appropriate from an employee's view: return, reward, or entitlement? Compare your ideas with someone with more experience, someone from another country, someone from another field of study.

"Traditional" college students will most likely focus on direct compensation only, since most students in this category will have expenses beyond their present earning capacity. "Non-traditional" students are more likely to focus on the total returns from work—cash compensation, benefits, and relational returns. When students compare their definition of compensation with others, it is hopeful they will gain a broader view of compensation. Be sure to emphasize that people's perspectives will vary; the differences in perspectives are likely to differ based on a combination of various factors such as age, occupation, family status, etc.

- 3. What is the “network of returns” that your college offers your instructor? What returns do you believe make a difference in teaching effectiveness? What “returns” would you change or add to increase the teaching effectiveness?**

The “network of returns” an instructor receives will depend on the type of college or university (example—research versus teaching orientation) he/she attends. Potential examples are provided below. Relational returns, moving beyond compensation and benefits are stressed upon.

If an instructor attends a research university, the most appropriate network is the probability to explore the chosen field of academics in detail, along with the ability to receive appropriate grants, scholarships, and be able to publish papers with ease. Laboratory facilities, opportunities to conduct case studies and organizational research should be available easily. In case the instructor is working within a team, it is essential that the university provide the team with advanced technologies to be able to communicate and carry out research. However, if an instructor attends a college whose mission is focused on teaching (e.g. small, liberal arts colleges), the most appropriate network would probably include extensive facilities that allow the instructor to access the latest studies, so as to be able to correlate the knowledge with the syllabi. Access to libraries, the Internet and attendance at seminars and conferences related to the instructors’ subject should be encouraged and the instructor must ideally be given a free hand in being able to explore various academic avenues within the scope of the syllabus and expanding and encouraging the spirit of questioning and understanding within the students. If the network is changed, teaching effectiveness could be affected. Academia typically provides higher pay for research effectiveness when compared to teaching effectiveness. Student recommendations will vary depending on the type of college or university attended.

- 4. What are the four policy issues in the pay model? What purposes do the objectives in the pay model serve?**

The four policy issues in the pay model are: (1) internal alignment; (2) external competitiveness; (3) employee contribution; and (4) management of the pay system. The basic objectives include efficiency, fairness, ethics, and compliance with laws and regulations. Efficiency can be correlated to improving performance, increasing quality, delighting customers, and stockholders, and also to controlling labor costs. Fairness is a fundamental objective that ensures fair treatment of all the employees by recognizing both employee contributions. Compliance as a pay objective means conforming to federal and state compensation laws and regulations. Ethics means the organization cares about how its results are achieved.

- 5. List all the forms of pay you receive from work. Compare your list to someone else’s list. Explain any differences.**

The different forms of pay will definitely depend on the types of jobs a student has held and

the nature of his/her work experience. The various types of pay include: (1) pay received directly as cash, including base, merit, incentives, and cost-of-living adjustments; (2) pay received indirectly (benefits), including retirement, medical insurance, paid time off, and programs to help balance work and life demands; and (3) relational returns, including the psychological, non-financial returns (e.g. recognition and status, employment security, challenging work, opportunities to learn, personal satisfaction from successfully facing new challenges, and teaming with great co-workers).

Comparisons of the types of pay will depend on the student's current and prior work experiences and the comparison person's work experiences. For example, students could compare financial incentives, such as piece rate production for a manufacturing position or commission pay for a sales position. Indirect pay benefits may include health insurance, life insurance, dental insurance, optical insurance, and prescription drug plans.

6. Answer the three questions in the *Caveat Emptor—Be An Informed Consumer* section for any study or business article that tells you how to pay people.

Note: Student responses will vary depending on the type of compensation article the student selects for analysis. To gain the maximum benefit from discussing this question, the instructor may want to assign a specific article for analysis. The following response to the three questions is based on research studies referenced in Chapter 1.

(1) Is the research useful?

Many studies use managers' opinions as measures of success. For example, Rynes, Colbert, and Brown (2002; see footnote #54) conducted a study that surveyed 5000 HR managers and compared their beliefs to the research evidence in several areas and identifies seven common and important misconceptions held by managers. The study authors concluded that being unaware of the key research finding may prove costly to organizations.

The types of variables used in research studies and how they are measured significantly impact the quality of the research results. For example, many studies purport to measure organization performance. However, there is a lack of agreement on which variable(s) to use to measure performance. This is evidenced by the many variables used to assess performance: accounting measures (return on assets or cash flow), financial measures (earnings per share or total shareholder return), operational measures (scrap rates or defect indicators), qualitative measures (customer satisfaction), and opinions of managers (i.e. how effective is your gain-sharing plan?).

Thus, answering the question, "is the research useful?" requires separating opinions from facts as well as assessing the value of the variables and how they are measured. Opinion data is just that—data about opinions. It demonstrates what people think or believe is occurring but may not indicate what is actually going on. Studies conducted on a compensation survey data showed HR executives reporting that their respective firms' target pay level was well above

the median.

(2) Does the study separate correlation from causation?

Empirical research studies typically employ statistical analysis techniques to analyze the variables of interest. The correlation coefficient is a common measure of association and indicates how changes in one variable are related to changes in another. A study conducted to explore the extent to which employee participation in the job evaluation process during the implementation of a compensation system influenced pay satisfaction, showed that increasing the involvement of employees in implementing a pay plan would increase their satisfaction with pay. The results indicated the level of employee participation in the job evaluation project did not correlate significantly with any aspect of pay satisfaction. Thus, a relationship did not exist between employee participation and satisfaction.

On the other hand, even if the results had indicated a relationship existed between increased levels of employee participation and satisfaction with pay, this relationship (measured by the correlation coefficient) does not ensure causation. For example, just because an organization involves its employees in a job evaluation program and their satisfaction with pay increases, it cannot be concluded that employee involvement caused an improvement in their satisfaction with pay. Other explanations—length of time since last pay increase, percentage of last pay increase, and pay grade level of the employee's job—may lie beneath the results. While the increased levels of employee participation and satisfaction with pay are associated, causation is a tough link to make.

Research on compensation often attempts to answer questions that do not involve causality. For example, the results of the study by Rynes, Colbert, and Brown (2002; see footnote #54) indicate a discrepancy between academic research findings and the beliefs of HR executives in several content areas of HR. This is a descriptive study, focused on providing benchmarking information; causation is not suggested.

(3) Are there alternative explanations?

Research studies focused on compensation often examine the impact of a certain type of pay program (i.e. merit or performance-based pay, team-based pay, gain-sharing) on a measure of organizational performance (i.e. customer satisfaction, company performance, productivity, quality) over a period of time. Researchers typically want to demonstrate that the introduction of a pay program will improve performance. Consider a hypothetical study with the following research question—if the performance measure improves during the time frame covered by the study, was the pay program responsible? Assuming performance improves, was the pay program responsible? Or, was some other variable responsible for the increased performance (i.e. change in leadership, use of new supplier vendors, and change in operating procedures)? The best way to establish causation is to explore competing explanations for the improved performance results, either statistically or through the use of control variables. Research

methodology emphasizes or “requires” that alternative explanations need to be accounted for to establish causality. It is often difficult to disentangle the effects of a pay program to clearly establish causality. However, it is essential to examine the overall pattern of evidence to make judgments about the effects of a pay program.

For example, it was found in a study of seven organizational characteristics, that the one that best predicted simulated organizational choice was pay for individual (versus team-based) productivity.