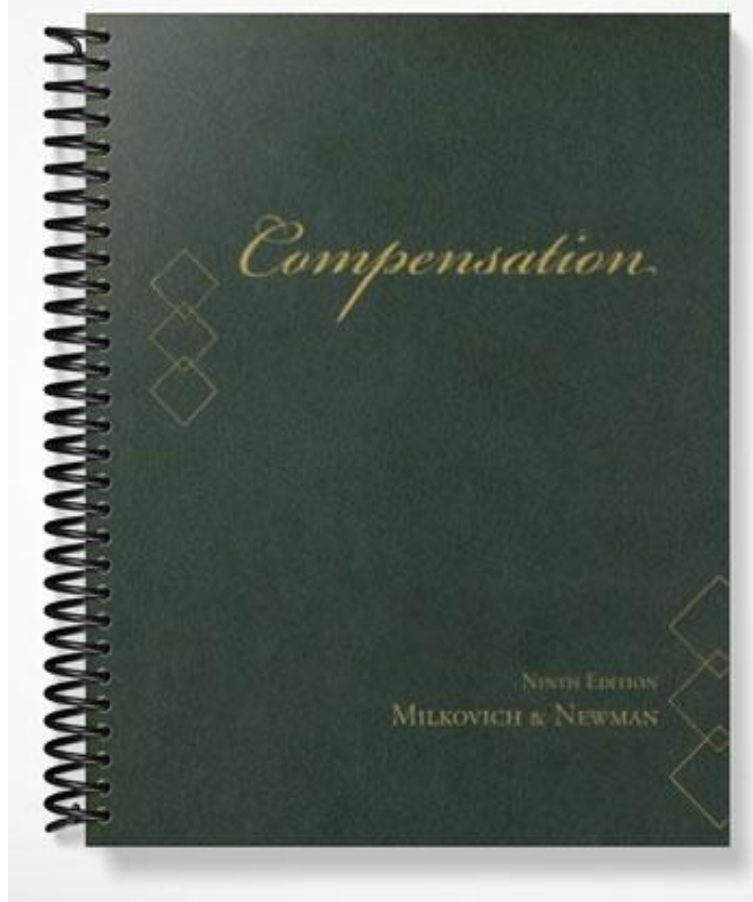


SOLUTIONS MANUAL



CHAPTER 2

STRATEGY: THE TOTALITY OF DECISIONS

Overview of Chapter 2

This chapter examines the key aspects of decisions taken during strategy creation on compensation. The key premise is that the way employees are compensated can be a source of sustainable competitive advantage. Two alternative approaches are highlighted: (1) “best-fit”/contingent business strategy/environmental context approach 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. Because the best-fit approach is the most commonly used, the steps involved 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.

Learning Objectives

After discussing Chapter 2, students should be able to:

1. Explain the idea of a strategic perspective to compensation.
2. Identify the five dimensions of a compensation strategy and how a compensation strategy can support an organization’s strategy.
3. Discuss how the pay model guides strategic pay decisions.
4. Understand the four steps involved in developing a total compensation strategy.
5. Discuss how three tests can be used to determine if a pay strategy can be a source of competitive advantage.
6. Describe the key arguments related to the two approaches – best-fit vs. best-practices – in developing a compensation strategy and system.

Lecture Outline: Overview of Major Topics

- I. Similarities and Differences in Strategies
- II. Strategic Choices
- III. Support Business Strategy
- IV. The Pay Model Guides Strategic Pay Decisions
- V. Developing a Total Compensation Strategy: Four Steps
- VI. Source of Competitive Advantage: Three Tests
- VII. “Best Practices” versus “Best Fit”?
- VIII. Guidance from the Evidence
- IX. Virtuous and Vicious Circles

- X. Your Turn: Mapping Compensation Strategies
- XI. Still Your Turn: Pay Matters (Productivity Does, Too)

Lecture Outline: Summary of Key Chapter Points

I. Similarities and Differences in Strategies

- A. Compensation strategies of three companies (Google, Medtronic, Merrill Lynch,) are compared and contrasted. Each company approaches the five dimensions (objectives, internal alignment, externally competitive, employee contribution, and management) of compensation strategy in different ways.

Exhibit 2.1: Three Compensation Strategies

- B. Different strategies within the same industry; **example** – Compensation strategy of SAS Institute, world’s largest privately owned software company.
 1. Emphasizes work/life programs over cash compensation
 2. Provides limited bonuses and no stock awards
 3. Offers free onsite child care centers, subsidized private schools for children of employees, two doctors on site for free medical care
 4. Provides recreation facilities
 5. Discourages working more than 35 hours per week
- C. Different strategies within the same industry or corporation will have very different competitive conditions, adopt different business strategies, and thus fit different compensation strategies.
- D. A simple “let the market decide our compensation” strategy does not work, either in the U.S. or internationally. Emerging labor markets in some developing countries and highly regulated labor markets in some developed countries are responsible for lesser movement of people than is common in the U.S., Canada, or even Korea, and Singapore.
- E. Strategic perspective on compensation is more complex than it first appears.

II. Strategic Choices

- A. *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: Strategic Choices

- B. 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?*

- C. 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. One current, popular theory proposes that pay systems should be aligned with an organization’s business strategy. The rationale is based on contingency notions.
1. Differences in a firm’s strategy should be supported by corresponding differences in its HR strategy, including compensation.
 2. Underlying premise – the greater the alignment, or fit, between an organization’s strategy and the compensation system, the more effective an organization.

Exhibit 2.3: Tailor the Compensation System to the Strategy

- B. The compensation systems might be tailored to three general business strategies:
1. Innovator: stresses new products and short response time to market trends; Compensation approach places less emphasis on evaluating skills and jobs and more emphasis on incentives designed to encourage innovations.
 2. Cost cutter: efficiency-focused strategy; stresses doing more with less by minimizing costs, encouraging productivity increases, and specifying in greater detail exactly how jobs should be performed.
 3. *Customer focused*: stresses delighting customers and bases employee pay on how well they do this.

- C. When an organization’s business strategy changes, the pay systems should change.

Example – IBM.

1. For several years, IBM emphasized internal alignment, e.g. elaborate job evaluation plan, clear hierarchy for decision-making, work/life balance benefits, policy of no layoffs.
2. To combat the lack of flexibility to adapt competitive changes in the new century, IBM now concentrates on diversified and advanced information technology, including hardware, software, services, and research.
3. To “fit” the revised strategy, IBM streamlined the organization by emphasizing the following features.
 - a. Cutting layers of management.
 - b. Redesigning jobs to incorporate more flexibility.
 - c. Increasing incentive pay to more strongly differentiate on performance.
 - d. Observing and monitoring costs constantly.

Exhibit 2.4: IBM’s Strategic Principles and Priorities

- D. If the basic premise of a strategic choice is to align the pay system to the business strategy, then different business strategies will translate into different compensation approaches.

IV. *The Pay Model Guides Strategic Pay Decisions*

- A. **Example** – Compensation system of Whole Foods.
1. *Objectives*: How should compensation support the business strategy and be adaptive to the cultural and regulatory pressures in a global environment?
 2. *Internal Alignment*: How differently should the different types and levels of skills and work be paid within the organization?
 3. *External Competitiveness*: How should total compensation be positioned against competitors?
 4. *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?
 5. *Management*: How open and transparent should the pay decisions be to all employees? Who should be involved in designing and managing the system?
- C. *Stated vs. unstated strategies* – all organizations that pay people have a compensation strategy.
1. Some organizations have a written compensation strategy that is shared with all employees.
 2. The compensation strategy of other organizations emerges from the pay decisions they make. Unstated compensation strategy is inferred from compensation practices.
 3. Managers in all organizations make the five strategic decisions discussed earlier. Some do it in a rational, deliberate way, while others do it more chaotically.

V. *Developing a Total Compensation Strategy: Four Steps*

- A. While the following steps are simple, executing them is complex. Trial and error, experience, and insight play major roles. Research evidence can also help.

Exhibit 2.5: Key Steps in Formulating a Total Compensation Strategy

- B. **Step 1: Assess Total Compensation Implications**
1. **Competitive Dynamics – Understanding the Business**
 - a. An organization needs to understand the specific industry in which it operates and how it plans to compete, e.g. its strategy.
 - b. Key factors to analyze include changes in customer needs, competitors' actions, changing labor market conditions, changing laws, and globalization.
 - c. Assess both the current status of the key factors as well as potential future changes in the factors.
 - d. After analyzing the impact of changes to the organization's strategy, determine if the compensation system should change to support the strategy.

- e. Analysis of the global environment is complex, especially when comparing pay systems; this is due to different pay practices and priorities. Organizations must be knowledgeable about competitive conditions even locally.

Exhibit 2.6: Toshiba's Managerial Compensation Plan, Annual Amount (in Yen)

Exhibit 2.7: Medtronic Values

2. Culture/Values

- a. 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.

3. Social and Political Context

- a. *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.
- b. Because governments are major stakeholders in determining compensation, lobbying to influence laws and regulations can also be part of a compensation strategy.

4. Employee Preferences

- a. Employees have different needs and wants from a pay system.
- b. 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.

5. Choice is Good. Yes, No, Maybe?

- a. Contemporary pay systems in the United States do offer some choices including flexible benefits and choices among health care plans.
- b. 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.
- c. In addition to possibly confusing employees, more importantly, unlimited choice would be a challenge to design and manage.
- d. Unlimited choice may also meet with disapproval from the U.S. Internal Revenue Service (health benefits are not viewed by the IRS as income).

6. Union Preferences

- a. Pay strategies need to be adapted to the nature of the union-management relationship.
- b. Although union membership among private-sector workers in the U.S. is less than 10%, unions do influence pay decisions.
- c. Unions' interests can differ.
- d. Compensation deals with unions can be costly to change.

7. Prominence of Pay in Overall HR Strategy: Supporting Player or Catalyst for Change?

- a. A pay strategy is influenced by how it fits with other HR systems in the organization.
- b. Pay can be a supporting player in the overall HR strategy, e.g. high-performance work system approach, or it can be a catalyst for change.
- c. High-performance systems generally include three features: (1) high skill/knowledge requirements, (2) work designed so that employee teams enjoy discretion in making decisions and continue to learn, and (3) pay systems based on performance.

C. Step 2: Map a Total Compensation Strategy

1. A compensation strategy is formulated based on the five decisions outlined in the pay model: objectives, alignment, competitiveness, contributions, and management.
2. Mapping is often used in marketing to clarify and communicate a product's identity.
3. Strategic maps offer a picture of company's compensation strategy and can be used to clarify the message a company is trying to deliver with its compensation system.

Exhibit 2.8: Contrasting Maps of Microsoft and SAS

4. **Examples.**
 - a. Microsoft's main message or "pay brand": Total compensation is prominent, with a strong emphasis on market competitiveness, individual accomplishments, and performance-based strategy.
 - b. SAS's main message or "pay brand": Total compensation supports its work/life balance. Competitive market position, companywide success sharing, and egalitarianism are the hallmarks.
5. Maps do not tell which strategy is "best." Rather, they provide a framework and guidance.
6. The remainder of the text discusses the five decisions in detail. It is the totality of the decisions that forms the compensation strategy.

C. Steps 3 and 4: Implement and Reassess

1. Step 3 involves implementing the strategy through the design and execution of the compensation system.
2. Step 4 focuses on reassessing and realigning as conditions and strategy changes; it closes the loop. Thus, periodic reassessment is needed to continuously learn, adapt, and improve.

VI. Source Of Competitive Advantage: Three Tests

- A. Three tests determine whether a pay strategy is a source of competitive advantage.
 1. *Is it aligned?*
 - a. Alignment of the pay strategy includes three aspects: (1) alignment with the business strategy; (2) aligned externally with the economic and sociopolitical conditions; and (3) aligned internally with the overall HR system.
 - b. Alignment is probably the easiest test to pass.

2. *Does it differentiate?*
 - a. Advocates of the strategic approach propose that sustained advantage comes from how the pay system is managed.
 - b. 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.
 3. *Does it add value?*
 - a. 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.
 - b. 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.
 - c. Of all three tests, this one is the most difficult to "pass."
- B. It is possible to align and differentiate and yet fail to add value.
- C. Are there advantages to an innovative compensation strategy?
1. In products and services, first movers (innovators) have well-recognized advantages that can offset the risks involved—high margins, market share, and mindshare.
 2. It is however, not known, whether such advantages accrue to innovators in total compensation.

VII. "Best Practices" Versus "Best Fit"?

- A. Premise of *strategic perspective (best fit)* – If the design of the pay system reflects the organization's strategy and values, is responsive to employees and union relations, and is globally competitive, the organization is more likely to achieve competitive advantage. The better the fit, the greater the competitive advantage.
- B. Assumptions of *best practices* – (1) a set of best-pay practices exists and (2) these practices can be applied universally across all situations. Based on these assumptions, several potential outcomes exist.
 1. Using best practices results in better performance with almost any business strategy.
 2. Adopting best-pay practices allows an employer to gain preferential access to superior employees.

VIII. Guidance from the Evidence

- A. There is consistent research evidence that the following practices do matter to the organization's objectives.
 1. Internal alignment
 - a. Smaller internal pay differences and larger internal pay differences can both be a "best" practice.
 2. External competitiveness
 - a. Paying higher than the average paid by competitors can affect results.
 3. Employee contributions
 - a. Performance-based pay can affect results.

- b. Answering associated question such as “are performance incentives a “best” practice?” is contextual in nature.
 - 4. Managing compensation
 - a. Rather than focusing on only one dimension of the pay strategy such as pay for performance or internal pay differences, all dimensions need to be considered together.
 - 5. Compensation strategy
 - a. Embedding compensation strategy within the broader HR strategy affects results.
 - b. Compensation does not operate alone; it is part of the overall HR perspective.
- B. A more useful question, “what practices pay off best under what conditions?” Much of the rest of this book is devoted to exploring this question.

VIII. Virtuous and Vicious Circles.

- A. Studies have reported that while pay levels (external competitiveness) differed among these companies, they were not related to the companies' subsequent financial performance.
- B. Performance-based pay works best when there is success to share.
- C. Performance-based pay that shares success with employees does improve employee attitudes, behaviors, performance (coupled with the other “high-performance” practices).
- D. While in cases where organization performance declines, performance-based pay plans do not pay off; with potentially negative effects on organization performance.
- E. Unless the increased risks are offset by larger returns, the risk-return imbalance will reinforce declining employee attitudes and speed the downward spiral.
- F. These studies do seem to indicate that performance-based pay may be a best practice, under the right circumstances.

Exhibit 2.9: Virtuous and Vicious Circles

Exhibit 2.10: Toyota and GM Pay Comparisons

Answers to Review Questions

1. **Select any company with which you are familiar. Or, analyze the approach your college uses to pay teaching assistants and/or faculty. Infer its compensation strategy using the five issues (objectives, alignment, competitiveness, employee considerations, and management). How does your company or school compare to Microsoft? To 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 Microsoft – support the business objectives and support recruiting, motivation, and retention.

Merrill Lynch – focus on customer, attract, motivate, and retain the best talent using fair, understandable policies and practices, there are differences in how they translate into action. 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 the company they selected.

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

The 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 the culture/values statements in Exhibit 2.7. Discuss how, if at all, those values might be reflected in a compensation system. Are these values consistent with “let the market decide”?

Medtronic's statement lauds stability, so it is 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) alignment 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.

Students answer will vary. Essential facts include the shift in ideology about higher pay being the only incentive for ones’ career. Evidence supports affective and cognitive aspects such as job satisfaction, motivation and innovation as being furthered by non-financial returns attributable to ones’ 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 ones’ 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.

Your Turn: Mapping Compensation Strategies

Summary of Case

Students must choose an organization they are familiar with. Using the concept of strategic mapping, they are to describe their organization's compensation strategy and compare it with the compensation strategies of Microsoft and SAS.

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.

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

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 a 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, 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.

Still Your Turn: Pay Matters (Productivity Does, Too)

Summary of Case

Students are expected to analyze how seemingly sound pay decisions can become obstacles to future competitive advantage. Using the analysis, they are expected to apply it to the auto plants of General Motors and Toyota.

Learning Objective

Look at the factors that shape a compensation strategy. Supply your inputs to go about building flexibility to a compensation strategy to make the process adaptable and resilient.

Discussion

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

Exhibit 2.5 depicts four simple steps in developing a compensation strategy. These include:
Assessing total compensation – implications, competitive dynamics, culture/values, social and political context, employee/union needs, and other hr systems

Mapping a total compensation – strategy, objectives, alignment, competitiveness, contributions, and management

Implementing a strategy – design system to translate strategy into action, and choose techniques to fit strategy

Reassess – realign as conditions change, and as strategy changes

While Toyota, and General Motors are similar on their manufacturing capacity, they substantially differ on approximate labor costs per vehicle. Students can examine aspects on: hourly workers, and the wages paid; and differences in compensation structure especially on the benefits.