Effective and appropriate direct compensation strategies and programs enable organizations to attract and retain the personnel they need and to motivate employees to help the organization succeed. They can also be used to communicate organizational objectives and priorities.

This white paper deals with formulating direct compensation strategies that fit the organization, designing programs that support the strategy and administering programs in an effective manner. Part One deals with the process of evaluating the organization's context and determining what its' direct compensation strategy should be. Part Two describes how base pay structures are developed in a manner which fits the needs of the organization and which enables it to ensure pay rates are equitable and competitive. Part Three describes the alternative ways of paying individual employees and provides guidelines for effective administration. Part Four deals with variable compensation programs.

**Part One: Formulating A Direct Compensation Strategy**

Any organization must utilize business, human resources and direct compensation strategies that fit the context within which they must operate, if there is to be any hope that the strategies are to be effective. Effective direct compensation strategies must:

* **contribute to:**
  - realizing the organization's vision/mission
  - meeting the organization's objectives
  - maintaining the viability of the organization's workforce

* **fit the:**
  - environmental realities
  - organizational realities
  - organization's culture(s)
  - organization's strategy
  - organization's structure

* **be well integrated with:**
  - organizational strategy
  - human resources strategy
  - tactical plans
Contribute To Realizing The Organization's Mission and Meeting Its' Objectives:
A typical mission statement for a newspaper would be: "to provide high quality, relevant information reliably, on a timely basis and at a reasonable cost to our readers." This mission statement may result in a strategy and in objectives that emphasize the integrity of the organization and its attention to quality, timeliness and dependability, thereby giving it a competitive advantage over other customer alternatives. A mission statement for a retailer might be “to clothe customers in a manner that fits their personality, income and station and to ensure their appearance helps them meet their objectives in life.” This statement focuses the resources and the attention of the organization on customer needs and meeting them. It is critical that the direct compensation strategy supports and contributes to fulfilling the mission and that the pay programs be designed in a way which encourages stability in key skill areas, provides incentives to perform at high levels and aligns employee interests with organizational objectives.

Fit Environmental and Organizational Realities: The political, social and regulatory environments impact the kind of pay system that is acceptable to key constituencies, and may prescribe pay levels which are acceptable. The economic environment, including the supply and demand for critical skills in the relevant labor market, will have an impact on what the organization must pay. And these two may be in conflict. For example, organizations converting their mainframe computer systems to client server network platforms are finding the competitive rates of pay for specialists in this new skill area do not fit well with the pay rates for other employees and raise issues concerning the employment of these specialists (vs. hiring them as contractors or outsourcing the function). A hospital may find that the relative pay levels between medical professionals and information technology personnel are causing dissatisfaction and feelings of inequity. These realities must be accommodated in the direct compensation programs and in the way they are administered.

Fit The Culture: The cultural orientation prevalent among workers will impact their perceptions about what is fair, competitive and appropriate with regard to remuneration. Some cultures emphasize individualism and even application of rules to all, while others believe the group is the dominant consideration and that rules should be varied according to the situation. Pay based on individual performance is dominant in individualistic cultures such as the U.S. and the U.K., but it is inconsistent with what people view as appropriate in collectivist cultures such as Japan and most of the Latin and Arab countries. Organizations that do business across country borders or who employ people from different cultural backgrounds must consider employee reactions to how they determine compensation or run the risk of having their programs viewed in a negative manner, thereby reducing their effectiveness in motivating performance and satisfaction.

Be Well Integrated With the Organizational and HR Strategy: The way in which people are paid will impact the effectiveness of the staffing and development strategies being used by the organization. If the kind of people hired, the way they are placed and developed and the way in which they are paid are in conflict, it will render the human resources strategy ineffective. For example, if employees are hired for their interpersonal skills, are trained to place the customer first, but yet are paid based on how long they have been in the job, the alignment of the HR functional strategies will be poor and results will be impacted.
In summary, the effectiveness of direct compensation strategies and programs is determined by how well they are aligned with the context within which they must operate. What works well in another kind of organization may not work in another; what works in one may be ineffective in another. It is the responsibility of management to ensure that compensation programs support organizational success and are consistent with the personality of the organization.

**Part Two: Developing Base Pay Structures**

Skilled personnel who have other employment options must feel their pay opportunity and pay level are equitable relative to other employees and competitive with what other employers pay if they are to be expected to join the organization and remain with it. Most organizations develop formal salary structures as control devices to use in administering pay. Structures consist of job grades (or “levels”) and salary ranges, which are assigned to each of the grades. Jobs are placed into grades based on their relative internal value and salary ranges are based on competitive pay levels. If employees feel they are inappropriately graded they will believe they are being treated inequitably. If they feel the ranges for their assigned grade are inappropriate they will view their pay as non-competitive. Rarely do employees feel their jobs are graded too high or that their pay rates exceed competitive levels... and feelings of overcompensation can be rationalized away almost instantaneously. If they feel undervalued or underpaid, however, the organization will have a difficult time controlling turnover and/or sustaining high productivity.

**Establishing Internal Equity: Job Grade Structures**

Most organizations use some form of job evaluation to assign relative internal values to jobs. Ranking the jobs from high to low, classifying jobs into predetermined levels and scoring jobs using quantitative point-factor plans are all methods used to develop an internal job worth hierarchy. Organizations that have greater longevity within their workforce than most other types of organizations are predisposed to fill jobs through internal reclassification and for them it is very important to create equitable relationships between job values. As a result, job evaluation systems are used widely in this type of organization, particularly point-factor plans that establish “scores” based on criteria relating to the skill, effort, responsibility and working conditions associated with each job. However, this approach to developing a job worth hierarchy requires a significant amount of time for initial installation and for maintenance.

Pay surveys are widely used for determining competitive pay levels... that is their principal purpose. But they can also help the organization establish relative internal job values, particularly in smaller organizations where the number of jobs is limited and there is valid market data available. The first step in designing a market-based salary structure is to use survey averages for the jobs as proxies for “job values,” which serve as the basis for assigning them to grades. The logic behind this is that the collective wisdom of all organizations as to what to pay incumbents of jobs is a credible basis for assigning them a relative value. Jobs are grouped into grades based on both their relative market value and the internal relationship between the jobs. Jobs of similar value are grouped together and those with unlike values are separated.
The next step is to realign the grade placements to reflect the specific characteristics of the organization. For example, one manufacturing organization may value the Finance function at a lower level because higher level activities are outsourced to a professional accounting firm or are performed by operating executives... the same might be true for its Information Technology function. As a result, the Top Financial Executive and the Top IT Executive might be placed in a lower grade than dictated by the survey averages, to reflect the realities of the way responsibilities are allocated and to reflect internal equity. If the organization differs significantly from other organizations in their industry this may argue for using a formal job evaluation system, since internal equity becomes more critical as the usefulness of market averages for grade assignment diminishes.

Survey data demonstrates the significant impact of organizational size on pay levels for management jobs. A hospital might use survey data from other hospitals of similar size (based on the number of beds), as might a manufacturing organization (based on gross sales). Although using data only from organizations of similar size makes sense for management jobs, it ignores the effect of geographic differences in pay levels. A more refined basis for classification would be a special sample of survey participants who were of similar size and who were located in the same geographic region or in areas having similar pay levels. For non-management jobs perhaps only the local area data would be utilized, since the labor markets for blue and white collar support personnel tend to be local. For professional jobs regional data may be used for entry-level jobs and national data for senior level jobs – perhaps industry data might also be looked at, with no consideration given to organizational size (Programmers in small organizations do not necessarily make less than those in larger ones).

The number of grades in a pay structure should reflect the characteristics of the organization developing the structure. Others might use more or fewer grades, depending on their reporting structure (how hierarchical or flat they are) and upon how many levels are defined within professional job families (a job family is a set of jobs involving work of the same nature but performed at different skill and responsibility levels). Flat organizations with few reporting levels and with few levels in job families might need fewer grades; more hierarchical organizations could need more. If Grade V jobs report to Grade IV jobs it would be unwise to combine these two grades, even if the average market rates were felt to be relatively close together. Formal hierarchical levels should be separated in grade structures to reflect responsibility differences, unless the organization believes the number of levels is excessive and needs to be changed. In the last few years an approach called “broadbanding” has been tried by organizations, with mixed success. This approach uses far fewer grades and much wider ranges. It has had great difficulty in organizations lacking managerial skill and budgetary discipline, since the ranges provide little control over salary actions. The principle underlying the creation of any pay structure is: Structures should reflect and be consistent with the structure of the organization and its culture. If a structure with fewer grades and wider ranges fit the context then that should be the approach used. If the organization has a hierarchical structure the appropriate structure may have more grades and narrower ranges.
Establishing External Competitiveness: Salary Ranges

Once the organization has created a job grade structure that reflects internal equity it can utilize prevailing market levels to establish salary ranges. If the organization has decided on a competitive posture that dictates setting pay ranges at relevant labor market levels (as opposed to exceeding or paying below prevailing levels) the market averages or medians can be applied directly to determining salary ranges. For organizations which own properties in different geographic areas or of different size a different set of ranges for each of their facilities might be considered for non-management jobs, unless average pay levels are similar for several markets, in which case they may be aggregated. The labor market for these jobs is local, whereas for management and senior level professional jobs it is regional or national, and consequently it is common for organizations to have one structure for them.

Salary ranges consist of a minimum, a midpoint and a maximum. The midpoint is considered to be the targeted pay level for people holding jobs classified within that grade, who have full command of their job skills and who perform at a fully acceptable level. The midpoint is typically set at a level that reflects the average of the market rates of jobs within the grade (unless the competitive posture is to pay above or below market).

The midpoints of salary ranges are most often based on the market averages for the jobs in the grade. Once the midpoint for each of the grades is calculated they should be adjusted to produce appropriate percentage differences between each of the midpoints. There is no “correct” midpoint difference, although it is common to have smaller differences in the lower end of the structure and larger differences in the higher grades, since each career progression tends to be more significant for managers and professionals than for clericals and operating jobs. The salary range spreads (between minimum and maximum) in this example are 50% at the top, narrowing to approximately 35% at the bottom. Spreads of this magnitude typically work out administratively, providing adequate opportunity for salary growth as an incumbent moves from entry-level competence to mastery. If the range is too wide, control over pay rates is sacrificed. However, if the range is too narrow, it is difficult to adequately reward those who distinguish themselves in their command of job skills and/or performance compared to expected standards. Each organization needs to make a decision about the width of their ranges, and culture will play a role, as will the manner in which pay actions are administered.

Part Three: Pay Rate Determination And Administration

Unionized organizations often make the assumption that single job rates or time-based "step-rate" structures are their only feasible option. This point of view is frequently the by-product of the nature of the bargaining relationship and the unwillingness of covered employees to trust management to appropriately administer pay for performance. Union free organizations also use time-based pay plans, however, because such plans are prevalent in the industry or in the local labor market. There certainly are obstacles to making performance-dependent pay systems effective. On the other hand, organizations should consider alternatives to paying based solely on time spent in a job - the disadvantages of the time-based step-rate system are often too great.
The pressures to deliver high quality service at a "reasonable" cost exist in most organizations in today's environment and they do not allow the luxury of assuming people will be productive when performance does not impact pay. When an employee's rate of pay is based solely on how long he/she has held a job, the employing organization will typically have difficulty controlling payroll costs and motivating employees to perform well. Under a time-based system, an employee must only survive on the job for a sufficiently long period of time in order to be paid substantially above the average market rate for the job. As a result, time-based pay raises costs without making cost increases contingent on the organization receiving the benefits derived from high levels of performance/productivity. It also sends a strong signal to employees that performance does not matter . . . which will typically send better performers elsewhere (where they will be paid for their contribution) and encourage those who are left to play it safe and to maintain their membership in the organization above all else.

A common dilemma for an organization that has used time-based pay for a number of years is to have most of its employees at the top pay rate in the schedule (a high cost work force) and complaints by these very well paid people that they only receive step schedule adjustments. This situation is even more troublesome if a significant number of these employees are not performing well in their jobs. Given these disadvantages, one might wonder why any organization would use time-based pay. There are some good reasons for doing so. Time-based pay allows an organization to predict costs with more certainty than does merit pay. It also avoids the difficulties associated with performance evaluation. Time-based pay works the best under the following conditions: 1) when many jobs are repetitive and routine, with small variation in performance possible, 2) where a collective bargaining relationship exists and there is not a high level of trust between the union leadership and management, 3) when employees do not believe managers are able or willing to fairly administer a merit program, 4) when budgetary limitations and/or customer rate pressures limit resources and require predictable costs, and 5) where there is concern about potential litigation and/or employee disagreement relative to performance appraisal ratings and the size of pay increases (the most often cited reason for public sector organizations using time-based systems).

What Are The Other Methods Of Administering Base Pay?

*Variable Timing Step-Rate Programs*: An organization which has a large percentage of its employees in jobs with short learning times and which involve limited performance variability (the kinds of job which best suit time-based pay) still has some options for recognizing very good or very poor performance. The variable timing step-rate approach incorporates a provision that allows managers to recommend double step increases or early step increases for those whose performance significantly exceeds standards; it also enables the manager to deny or delay the step increase for those whose performance does not meet expectations. Although this system provides a limited number of choices relative to the size and frequency of increases, it can help organizations acknowledge significant performance differences. It does mandates that performance criteria and performance standards be established and that individual performance be credibly measured using those standards. If a formal performance appraisal system does not exist, there is a danger that the option to vary the size of increases will be used incorrectly or in a discriminatory fashion. The lack of sound measurement also leaves the organization open to challenge, and even litigation.
A number of organizations have used the variable step rate system as a transitional device to get from time-based pay to performance-dependent pay. This is a way to phase into performance appraisal gradually, since only exceptional and unacceptable performance need be reliably identified. On the other hand, many organizations make it very difficult for managers to do anything but give a single step increase on schedule. Managers who attempt to vary from the schedule are often burdened with an additional 5 lbs. of paperwork and are made to feel like misfits. It does not take them long to revert to a de-facto time-based system if this happens.

**Combination Step-Rate/Merit Pay Programs:** Organizations with large numbers of employees working in jobs which have fairly standard learning times but in which incumbents can vary performance significantly once the job skills are learned may wish to consider an approach which combines time-based and performance-based pay. This combination program provides step increases to the range midpoint based on time (though there may be some variability, as described in the prior approach). Once the employee is being paid at this "control point" for the job, further increases may be subject to a performance test. The employee who is paid at the control point and who performs at a "fully meets standards" level will have his/her pay rate adjusted when and by the amount the pay range is adjusted - the employee will stay at the control point as long as performance stays at that level. An employee who "exceeds standards" or is "outstanding" may move above the control point.

There is much to argue for this approach, particularly if the organization finds it difficult to differentiate between employees based on performance while they are learning the job. Once an employee is paid at the control point, it can be argued that "fully meets standards" performance does not warrant increases above that level. It is assumed, of course, that the control point is set at a level consistent with pay levels prevailing in the relevant labor markets and consistent with the organization's competitive posture relative to the market. On the other hand, those who perform at higher levels have the rest of the range available to them.

Employees whose performance declines below the level that justifies the pay rate would receive no or small/less frequent increases, which would over time realign their pay rate to reflect their contribution. This is consistent with the philosophy of paying for performance, rather than giving increases for performance; that is, if an employee is already paid significantly above the level justified by performance, no further increase may be warranted. A disadvantage of the combination approach is that it necessitates effective communication about the "change in rules" when the control point is reached. An even greater potential disadvantage is that it places considerable pressure on the performance appraisal system of the organization. Since something significant is now at stake, employees will subject the performance appraisal methodology and the process to greater scrutiny. Another consideration is the spread of existing pay ranges. If the prior pay system utilized relatively narrow ranges (30% from minimum to maximum, for example) the organization may wish to widen the ranges somewhat when adding the merit zone. This allows for most of the existing steps to remain steps and tends to minimize the perception that the organization is "taking back" guaranteed increases to pay. On the other hand, that may be precisely what the organization wishes to do, particularly if previous ranges were very wide and the top steps are at indefensibly high levels. For other than senior management it is rare to need ranges wider than 40-50%.
Performance-Based (Merit) Pay Programs: A third option is to make the transition to a full merit pay program. A merit pay program utilizes pay ranges with no predefined steps within them. The midpoint or middle third of the range are typically the targeted level for "fully meets standards" employees who have a full command of the knowledge, skills and abilities required to perform at a competent level. Often there are also "penetration points" defined within the range for each performance level and the rate at which any employee's pay rate moves to the target is based on that employee's performance (e.g., only sustained outstanding performance will move an employee’s rate into the upper third of the range and those who have not attained full job mastery may be limited to the lower third of the range).

The salary increase guidechart below illustrates the philosophy underlying merit pay. It prescribes the largest increases for high performers paid low in the range and the smallest (or no) increases for those paid high in the range and whose performance does not warrant that pay.

<table>
<thead>
<tr>
<th>Performance Rating</th>
<th>Lower Third</th>
<th>Middle Third</th>
<th>Upper Third</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding</td>
<td>$$$$</td>
<td>$$</td>
<td>$</td>
</tr>
<tr>
<td>Significantly Exceeds Standards</td>
<td>$$</td>
<td>$</td>
<td>$</td>
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<tr>
<td>Fully Meets Standards</td>
<td>$</td>
<td>$</td>
<td>½ $</td>
</tr>
<tr>
<td>Does Not Fully Meet Standards</td>
<td>0 - $</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Unacceptable</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Invariably employees who perform well but who are at or near the top of the range feel a small increase is not fair. However, it is fair, since that person is being paid substantially (e.g., 15-20%) above market and the organization has a right to expect high performance for the high rate of pay. In fact, the organization has a right to ask for a refund if performance drops off, even though it is unlikely to attempt collection. HR/Compensation practitioners must make every effort to communicate this philosophy to everyone and to train managers in the administration of a true merit plan. A sound performance appraisal system is a key to successful merit pay programs. Another key is ensuring managers have the skills and knowledge required to appraise performance effectively. Much of the difficulty experienced in making performance appraisal effective is a result of under-investment in managerial training and employee communication. The lack of attention to developing a credible process and convincing employees that it is equitable also contributes substantially to failure.
Person-Based Pay Programs: An approach that differs significantly from the options already discussed is "person-based" pay. Person-based pay programs pay employees for what they can do rather than what they are doing. An Engineer could logically be paid for the relevant knowledge he/she commands, even though for extended periods the work performed does not require these qualifications. A mechanic may be paid for the number of job-related skills he/she has mastered, even though some of them may be rarely used. The best applications of the various types of person-based pay are in units where the work is highly interdependent, cooperative/ supportive behavior is required, flexibility of work assignment is needed and where the skill/knowledge utilized is reasonably stable. Organizations using quality circles, work teams and other forms of employee participation find that employees tend to make greater contributions when they are motivated to increase their job knowledge and their skills.

Care must be taken to ensure that relevant skills/knowledge can be defined and that mastery can be determined reliably before a person-based system is adopted. Particular attention should be given to the process by which mastery is tested and to who does the testing. Often peers and supervisors find saying "no" has undesirable consequences and decide to operate the system more like a seniority program. The organization must also ensure that a payback will be forthcoming from a multi-skilled workforce; the average pay levels will typically rise as incumbents mature under the system and in order for productivity to be maintained there must be some offsetting benefits, such as lower staffing levels. A person-based pay system may not work for all occupations within an organization…it must be decided if the organization's culture will support multiple approaches to administering pay. Many organizations find different pay systems for different groups to be politically contentious or administratively impractical.

There was a great deal of discussion about “competency-based” pay in the late 90’s, although there was little actual adoption of this approach. The most common models attempted to develop levels based on behavioral competencies and then to classify individuals into these profiles. Two major problems presented themselves: 1) the criteria tend to be both complex and abstract, thereby making it difficult for managers to use them reliably, and 2) developing competencies that could be validated by tying them to jobs is enormously expensive.

Part Four: Variable Compensation

Short-term Plans

An organization must ensure its total direct compensation levels (base pay plus variable pay) are equitable and competitive if it is to compete effectively for the right people. Even if its base pay structure has been equitably and competitively established the organization may find that competitor organizations pay annual incentive awards that make total direct compensation levels inadequate. Market surveys are useful for determining total direct compensation levels as well as base pay levels, since this information is typically accumulated and reported. Most incentive compensation programs are designed using "target award levels;" that is, incentive award levels (expressed as a percentage of base pay) that will be paid for meeting the business plan/established objectives. Scales are then created that allow for incentive awards that are less or more than the target.
The pattern of incentive plan targets most frequently employed across industries is to have increasing amounts (as a percentage of pay) "at risk" in the form of incentive as one moves up from lower to higher levels. A typical profile would be to set the CEO's incentive target at 25-75 percent of base pay, top functional executives at 20-50 percent and Directors/Department Managers at 15-25 percent. There are wide variations between industries, so industry data should be looked at where appropriate. One must be careful not to judge incentive plan design by payouts in any given year; a more credible basis is to evaluate incentive targets for each job, which reflect the "typical" or "planned" incentive award. The incentive awards in a given year can be impacted materially by the economic conditions prevailing in the entire industry.

If an organization decides to set both base pay and incentive pay levels "at market," the differences between average base pay levels and average total direct pay levels from the survey provide average cash incentive awards. Market incentive levels for specific jobs may not align well with the grade assignments a specific organization establishes, because of the very different variable pay components for different occupations. For example, sales jobs typically have higher incentives and often have lower base pay levels than professional or management jobs. It is therefore necessary to consider taking sales jobs out of the base pay structure and placing them into a separate structure.

An organization may decide that incentive compensation does not fit its culture or that management is not comfortable with its ability to measure individual performance in a defensible manner, particularly with the pressure that a cash incentive plan puts on this process. That organization could elect to set its base pay structure at competitive total direct compensation averages and not use variable pay at all. This strategy has a downside, since it makes compensation costs fixed, rather than variable based on business results. It also lessens the motivational impact of the pay program, since poor performance will incur, at the very worst, no increase; not much of a penalty if an employee is already paid at or even above competitive levels.

Another organization may decide to set base pay levels significantly below average total direct compensation levels and to provide a large incentive opportunity. This strategy, if properly implemented, would provide below market total direct compensation levels if performance is poor, at market compensation levels if performance meets standards, and above market compensation levels if performance exceeds expectations. Using variable pay aggressively does enable the organization to reduce costs when results are poor, but it also places a great deal of pressure on the performance measurement and incentive award determination criteria. Each organization must be sure that the risk-reward tradeoff in the direct pay package is viewed as fair and competitive and that measurement is both based on appropriate and accurate.

The organizational level at which performance should be measured and rewarded will have an impact on the types of incentives considered. If the organization wishes to elicit individual behaviors and/or results, then some type of individual incentive program would be the most feasible. If, on the other hand, work is of a highly interdependent nature or cooperative/supportive effort at the work team or organizational unit level is needed, then some form of group incentive program would be likely to fit the best.
There are different *individual incentive* approaches:

1. **Using lump-sum bonuses to recognize performance, rather than using increases to base pay.** For individuals who reach the top step in time-base programs, an organization can still offer annual awards to exceptional performers and those who must be retained. This approach can also be used when base pay rates have gotten too high relative to some standard (i.e., market average) and which must be controlled to prevent further escalation.

2. **Using cash incentive awards to supplement base pay increases for outstanding performers.** No matter how base pay rates are administered, it is sometimes desirable to have tangible, short-term reinforcement of outstanding behavior/results. Using cash awards enables the organization to bypass the established annual cycle of reward allocation and to make payouts close in time to the behavior/results being rewarded. For example, awards may be paid when a project is completed in an outstanding manner, deemed to be deserving of something beyond what the base pay administration program can provide.

There are also a number of *group incentive* approaches:

1. **Gainsharing:** Formula based incentive programs that use measures such as productivity or cost and which share gains with employees – such a system often works well in production operations.

2. **Cash Profit Sharing:** Formula based incentive plans based on profitability and which share a percentage of profits with employees – this system can apply to all employees and can serve as a “shared destiny” plan.

3. **Group/Unit Objectives:** Objective-based incentive plans which identify criteria, set standards and measure results against standards.

### Long-Term Incentive Compensation

Prevailing practice in U.S. industry is to add some form of long-term incentive compensation to complete the annual direct compensation package, at least for at least the key executives. Several types of programs are commonly used, but they typically break down into cash-based programs and equity-based programs. Cash plans are very similar to short-term incentive plans, except that the measurement period and/or payout frequency is longer than one year. There has been increasing usage of long-term cash plans over the last 10 years, but these plans are still not in place in a majority of organizations. Privately held organizations often use cash plans that simulate how an equity plan would operate, in order to keep their total compensation package competitive with publicly traded organizations.

Equity-based plans are of many different types and can be exceedingly complex in their design, but they can be categorized under three types. *Purchase plans* enable employees to buy stock, often assisted by the organization and sometimes at a price below fair market value. *Grant/Restricted stock plans* award stock to selected employees without any cash investment required of the recipients. These plans are almost always limited to very senior executives (no more than 1 percent to 2 percent of employees in larger organizations). *Option plans* are by far the most commonly used equity-based long-term incentive plan; over 90 percent of the Fortune 500 companies use them.
Option plans are popular because the equity markets are in essence funding the gain realized by executives and very often these gains never have to be charged against earnings. Additionally, gains realized by the executives at time of exercise can be a tax deduction for the organization and there is a positive cash flow at that time. On the other hand, options only have value if the price appreciates and there have been many tales of woe over the last two years, particularly in organizations where this device has been overused. As with short-term incentives, each organization must decide whether long-term compensation plans make sense given its objectives and its culture. If stock ownership is closely held the use of equity plans may not be possible or not desirable from the perspective of current owners.

**Conclusion**

Every organization must define it's mission, understand the context within which it operates and develop a strategy and structure for meeting its' objectives. The human resources strategy it adopts must contribute to its' success and enable it to attract, retain and motivate the workforce required for high levels of performance.

The direct compensation strategy and programs utilized must also fit the context and contribute to organizational effectiveness. Pay rates must be equitable, competitive and perceived as appropriate by all constituencies. If management believes paying above market averages for some or all occupations produces benefits it must weight those benefits derived against the costs. If it believes paying for performance fits the organization's context and provides more advantages than disadvantages there are a number of options open. The amount of resources available to the organization (money, management skills, freedom from regulatory/citizen intervention, etc.) should be a major consideration, and one that should be considered early in deliberations. The impact on employees is also a critical concern.

The direct compensation strategy and the programs that are best for an organization must be determined by each organization. What is important is that the pay system used is effective and appropriate, given the organization's mission, culture, environment objectives, strategy and structure.
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Global Remuneration Organization: course designer and faculty member for the GRP certification program at its inception.  
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