**APPLYING YOUR KNOWLEDGE**

***Compensation and Incentive Pay at Shaver Inc.***

"I don't understand it. We're a successful company that pays well, and we have a rep­utation to uphold. Now you tell me that last year most of the raises employees got were *not* given on the basis of performance. How can that be?" So asked Shaver Inc.'s chief executive officer, Phyllis Johnstone. Mike Mercer, Shaver Inc.'s vice president for human resources, fumbled for an answer. "Well, we've got a darn good compen­sation system. The problem is simply that managers don't know how to use it effectively."

This exchange of views prompted Mercer to return to his office and think about the journey that he and his salary review task force had begun several years ago. This task

**Case *11-1***

**452**

*Part 4 Compensation*

force, which involved employees from virtually every division at Shaver Inc., had re­viewed the earlier compensation system and had instituted a series of changes designed to make the system more effective. But apparently the changes had not been very suc­cessful, and Mercer was on the horns of a dilemma.

**Company Background**

Shaver Inc., a manufacturer of all kinds of wood and steel tables for business and in­dustry, was headquartered in Eugene, Oregon. Its roots date back to 1907, when founder Jason Bishop started up a new business near a sawmill on the outskirts of Eugene and developed a uniquely crafted writing table for bookkeepers. The business initially was family owned and remained relatively small until the 1940s. By then, however, outside investors had begun to take an interest in the quality of workmanship that was demon­strated by the Bishop family, and they purchased the business and began to expand its operations both domestically and overseas. The organization was incorporated in 1952 and continued to expand rapidly throughout the 1950s and 1960s. Today, Shaver manufactures and markets more than 40 varieties of tables and is the leader in the western United States in this particular business.

Shaver enjoys a reputation for excellent management practice and has been written up in numerous business magazines over the years. It consistently receives high ratings for product innovation, return on stockholder investment, product quality, and financial acumen. It also receives high marks for its ability to attract, develop, and retain talented employees.

Shaver has also traditionally been a very profitable organization, which is what at­tracted the initial investor interest in the 1940s. Until 2002, Shaver had always out­performed its competitors in terms of return on investment for its shareholders. For instance, in 2000, Shaver's return on assets averaged 15 percent while that of its largest competitor averaged only 11 percent in the same year. However, in 2002 the sit­uation began to change. Shaver's traditional lead over its competitors deteriorated, possibly due to changes in organizational structure or to a set of disappointments in new-product innovations in the marketplace. CEO Johnstone was not convinced that only factors such as these were to blame for some of Shaver's problems. She was con­cerned that perhaps employee motivation was deteriorating as well, and her impres­sions of the salary and compensation system did not provide her with any comfort in this regard.

**Compensation Policy at Shaver**

Shaver Inc. employs about 16,000 people, roughly half of whom are hourly manufactur­ing or clerical employees. The other half are salaried exempt employees, including salespeople, engineers, technicians, supervisors and managers, and others. Compensa­tion for the 8,000 exempt salaried employees at Shaver has historically ranked among the top 33 percent of midsize U.S. corporations. These progressive HR policies and pay practices have contributed to inordinately high levels of employee commitment and loy­alty, as characterized by historically low voluntary turnover rates (averaging less than 4 percent of the workforce per year).

As with other companies, the salary determination process at Shaver was built on the annual performance review. Shaver's existing performance review process had been designed and developed by Mercer's salary review task force in 2000. Under this plan, supervisors rated employees on a scale from 1 to 5, with 5 designating excep­tional performance and 1 indicating unacceptable performance. Plus and minus ratings were allowed, with the exception that no one with a 5 could earn a plus and no one with a 1 could earn a minus. Thus, managers could choose from 13 different rating categories in assigning an overall performance evaluation for a particular employee (5, 5-, 4+, 4, 4-, etc.).

*Chapter 1* / *Pay and Incentive Systems*

**453**

Salaries for the 8,000 exempt employees at Shaver were based on a combination of job characteristics and merit. The job characteristics were measured using "Hay points." Hay points were determined by evaluating each position at Shaver in terms of the three Hay factors—know-how, problem solving, and accountability. For each job, numerical scores were assigned to each of the three factors according to guide charts provided by Hay Associates. The guide charts revealed what was meant by know-how or one of the other compensable factors. Each compensable factor was bro­ken down in terms of more specific building blocks to make the process as objective as possible. The total number of Hay points for each position in the organization was calculated by summing the points given on each of the three compensable factors. At Shaver, Hay points were then converted to a "a control point" (which equated roughly to an average monthly salary) using a salary-line formula. For example, in 2004, the salary-line formula was as follows: Control point = $1621 + $3.23X (where *X* = number of Hay points).

With this formula, an employee with 550 Hay points had a 2005 control point of $3,398 per month. At Shaver, the employee's actual salary could range from 80 percent to 125 percent of the control point. Actual salary as a percentage of the control point is called the employee's *compa-ratio.* For example, an employee with 550 Hay points and a compa-ratio of 110 would have a 2005 monthly salary of $3,737. On the other hand, an employee with 550 Hay points and a compa-ratio of 80 would have a 2005 monthly salary of $2,718. Each employee's compa-ratio goes down whenever the salary line formula is moved upward and goes up each time he or she gets a merit salary increase.

Shaver, Inc. has always prided itself on being an organization that pays above-average salaries. It sets its salary line formula so that employees with compa-ratios of 100 earn approximately 10 percent more than the average compensation in other medium-sized organizations. This means that an employee at Shaver in a position with 550 Hay points would earn roughly 10 percent more than a similarly situated employee with 550 Hay points at another organization, assuming that both had similar compa-ratios. To guarantee that Shaver is paying about 10 percent above market, it takes part in a variety of salary surveys each year. In these surveys, it sends its salary data in and re­ceives reports back from the surveying organization showing how its salaries compare with those of other organizations.

The salary-line formula is revised annually on July 1, the beginning of Shaver's fiscal year. The salary-line formula is adjusted upward so that control points for particular positions are approximately 10 percent above the market-salary goal that Shaver sets for itself. However, the salaries themselves are not automatically adjusted when the salary line formula changes. Instead, individual compa-ratios decline every July 1, when con­trol points are increased.

**Merit-Pay Increases**



Salary revisions themselves are linked both to control-point increases and performance appraisal ratings through guidelines established by Mercer's HR management depart­ment. Theoretically, employees with higher performance appraisal ratings should get larger pay increases, and raises for a given performance rating should be smaller for em­ployees with higher compa-ratios. For example, the salary increase for an employee re­ceiving a performance rating of 4 might be in the 5 to 7 percent range if his or her compa-ratio is 90, but only in the 3 to 5 percent range if his or her compa-ratio is 110. Employees who achieve compa-ratios considerably above 100 over an extended pe­riod of time are generally viewed as the star performers at Shaver. This level of sustained performance suggests that the individual is a clear candidate for promotion. In addition, because salaries are rarely decreased, compa-ratios may be above 100 in the short run for employees who are not performing particularly well and, therefore, not actually candi­dates for promotion.

**454**

*Part 4 Compensation*

The maximum obtainable compa-ratio is 125. Thus, salaries are effectively capped at 125 percent of the control point, and employees near the cap can receive up to, but cannot surpass, the cap during each annual merit-salary increase. In practice, however, only a few employees achieve and maintain compa-ratios exceeding 115. One reason is that the salary line formula is adjusted prior to salary revisions each year. Therefore, even employees hitting the cap in a particular year will likely be well below the cap af­ter the salary line changes on July 1. The second reason that few employees maintain a salary close to 125 percent of the control point is that those with high compa-ratios are frequently promoted once they attain that level of salary. Because it takes time to learn the skills necessary in a new position, the starting compa-ratio for a newly promoted employee is almost always lower than his or her final compa-ratio in the previous posi­tion. For example, in 2004 the average starting compa-ratio for all employees promoted into positions with 500 Hay points was 85.

**Performance Appraisal at Shaver**

Back in 2000 when Mike Mercer and his salary review task force had looked into the problems associated with compensation and the performance appraisal system, they had discovered through interviews that there was general agreement that rewards for ex­cellent performance were inadequate. Outstanding performers were getting salary in­creases that were in many cases only marginally better than those given to average and below-average performers. And in many cases, outstanding performance was not even being identified through the appraisal system.

The salary review task force had redesigned the appraisal system so that it looked like the 5-point scale described earlier, and this revision had been implemented in 2001. It was the hope of the task force that this redesigned system would help overcome some of the problems that were uncovered during the interviews. According to Mercer, "One thing that really hit home for us was the negative feeling of some of our best performers concerning the reward system here at Shaver. The key issue seemed to be the appraisal system itself and it simply had to be dealt with."

The problem was that everyone seemed to have different ideas about how to re­structure the performance appraisal system. The salary review task force got a variety of opinions, mostly negative, about the existing appraisal system. Many pointed out that managers were afraid to give experienced people ratings below 8 (the old system had been based on an 11-point rating scale). They also pointed out that it was very difficult to get/a rating of 10. In many cases the supervisor had never received a rating of 10 and was not about to give that rating to a subordinate. Some other comments that were rep­resentative of problems uncovered included:

What's the use of working hard? You still get the same rating everyone else does, and you still get the same 4 percent salary increase. It's demoralizing and demotivating.

Sharlene has been in that job for 11 years and hasn't done anything extraordinary for the last 8. But do you think my boss would give her a 7? No way! If he did, he'd spend the next year listening to Sharlene complain about her rating.

How can I evaluate my direct reports fairly and objectively when the other man­agers are giving all their people 8s? A 7 simply isn't acceptable. The system would be okay if everyone played by the same rules, but they don't.

It's getting to the point where many of the best people are going to leave Shaver un­less they get the right kinds of rewards. Now, who do you want to do the walking? Your best people or your worst?

It was with these problems in mind that the salary review task force undertook the redesign of the performance appraisal system in 2000. The results of appraisal ratings

*Chapter* ? *1 Pay and Incentive Systems*

455

and salary increases in 2004 for all salaried exempt employees are presented in the fol­lowing table. It was the information in this table that Mercer presented to Johnstone that created the incident described at the beginning of the case.

**2004 RATING DISTRIBUTION AND AVERAGE PAY INCREASE UNDER THE 2001 PERFORMANCE APPRAISAL AND SALARY ADMINISTRATION PROGRAM**

|  |
| --- |
| Average 2004 pay increase |
| 2004 rating | Number of employees | Percentage distribution | Compa-ratio Compa-ratio 80-94 95-109 | Compa-ratio 110-125 |
| 5 | 16 | 0.2 |  |  |
| 5- | 49 | 0.6 | 9.3% 8.7% | 6.5% |
| 4+ | 1,421 | 17.6 |  |  |
| 4 | 2,447 | 30.4 | 6.5 5.5 | 4,8 |
| 4- | 1,471 | 18.3 |  |  |
| 3+ | 1,394 | 17.3 |  |  |
| 3 | 876 | 10.9 | 5.9 4.8 | 4.1 |
| 3- | 281 | 3.5 |  |  |
| 2+ | 63 | 0.8 |  |  |
| 2 | 27 | 0.3 | 4.4 1.9 | 0.1 |
| 2- | 1 |  |  |  |
| 1+ | 1 |  |  |  |
| 1 | 4 |  |  |  |

Questions

1. What are the problems with Shaver's present performance appraisal and salary
review program?
2. What changes in Shaver's performance appraisal and salary review system would
you recommend?
3. Discuss the rationale and relative advantages of each of the changes you
recommend.

**REFERENCES**

1. Bates, S. (2003a). Top pay for best performance. *HRMagazine, 48* (1), 31-38.
2. Milkovich, G. T., & Newman, J. M. (2005). *Compensation* (8th ed.). Burr Ridge, IL:
Irwin/McGraw-Hill
3. See, for example, Cascio, W. R, & Wynn, P. (2004). Managing a downsizing
process. *Human Resource Management, 43* (4), 425—436.

Milkovich & Newman, op. cit.