

CASES
in
COMPENSATION
fifth edition

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INTRODUCTION

This case book provides you with hands-on experience making decisions about paying people. It will help you understand the concepts and techniques discussed in the Milkovich and Newman textbook *Compensation*. You will have the opportunity to actually apply the techniques you have read about. The projects will expose you to a rich variety of problems and challenges that confront actual managers.

The assignments are similar to the phases of the pay model used in the text. Interrelationships among the phases will become clearer as you progress through the projects.

In addition, a number of additional projects are included at the end of the manual. These projects cover topics that are of contemporary interest, yet may be beyond the time allotments for your course. Projects to build your skills in employee benefits, gainsharing, performance management, executive compensation, and international compensation are included. We believe you will find the topics compelling, fascinating, and intrinsically motivating. But then, we believe that anything to do with compensation is compelling, fascinating, and intrinsically motivating. Your in-

Phase I: Internal Consistency: Design an internal structure based on the work and its relative importance to the organization objectives.

Phase II: External Competitiveness: Price the structure based on external market forces and other factors.

Phase III: Performance Contributions and System Administration: Vary individual pay according to performance; manage the system, and control costs.

structor will fit these projects to the class objectives. Your overall assignment is to design a pay system for Medtech. Medtech is a composite of several companies. In designing the company's system, you will learn how to apply basic compensation techniques. A

main theme in the textbook is that managers must align their compensation decisions with the organization's business strategy, values, and unique circumstances. Here is your chance to do this. More importantly, the assignments also will help you learn why. You will discover that different solutions are possible under the same circumstances. So be sure to explain how and why your

decisions will help achieve Medtech's objectives and minimize potential problems.

We hope you will enjoy working on this case and discussing possible approaches with other students and your instructor. Our objective is to help you increase your knowledge and interest in compensation. Whether you become a manager who makes pay decisions or an employee who receives pay, it's in your own best interest to learn about pay systems in order to make them work for you.

THE SETTING AND YOUR ROLE

All the decisions take place within Medtech, a company that has hired you to bring some order to the way their employees are paid. Combine the information in this manual with the information in your textbook, your class discussion, and your instructor's directions to arrive at your recommendations. If you skim the appropriate chapters in the text before you begin each phase, you will have a better sense of the requirements of each phase and what decisions you face at Medtech.

Medtech does not have a formal compensation plan; little overall thought is given to employees' salaries. At first you may ask, "What are the steps to follow?" "What does my instructor want?" But as your experience and understanding increase, so will your ability to specify and achieve the results you desire.

At times you may wish you had more information about Medtech. But in the real world, information is frequently flawed or not readily available. Base your decisions on the information you possess. One of the challenges facing any manager is to bring direction and understanding to ambiguous and often chaotic situations. So, too, at Medtech.

As you go through each phase of the case, keep track of any additional information you feel would have improved your compensation decisions. In the last project, you may recommend future projects to improve the system at Medtech.

Format

Your reports can be written as recommendations to Medtech's management. Link each recommendation to Medtech's compensation objectives. The con-

stant question to address is, so what? What difference does this make? How does this recommendation help Medtech sustain its competitive advantage? Include your rationale, possible alternatives, and potential risks. Your written report does not need to be lengthy, but it should be complete.

Preface your report with an executive summary highlighting major recommendations. Make use of charts and graphs. Use data from your analysis to support your recommendations.

YOUR FIRST PROJECT AT MEDTECH: RECOMMEND OBJECTIVES

Congratulations! Medtech has just hired you as their compensation person. You start today. Chapter 1 of the Milkovich and Newman text *Compensation*, this casebook, and your instructor will be your sources of information for completing this project.

Medtech has decided it requires a compensation

Your instructor may ask you to make an oral report to Medtech's management committee (your classmates) on the day your assignment is due. Oral presentations serve two purposes. First, oral presentations allow comparisons of recommendations among classmates. It is always useful (and amazing) to see what others, given the same set of information, recommend. Second, the experience in summarizing and presenting proposals will help you in your post-college career.

system that reflects its changing strategic direction and vision. In meeting with Medtech's CEO and the Director of Human Resources, you have decided that it makes sense to start by recommending objectives for the pay system.

Begin this project by reading Medtech's history.

BACKGROUND ON MEDTECH

Medtech is a medical supplies company located near Chicago. Its products include relatively low-tech items, such as disposable needles, as well as high-tech equipment for kidney dialysis and laser treatment. Medtech's founder Dr. Eddie Eagleman was the original driving force behind the company. He combined the roles of cheerleader, cajoler, and coach.

Stories about him abound. One is how he often told anyone who would listen, "I find the best and brightest people, give them a sense of direction, then get out of their way." Medtech thrived under his leadership. Technological breakthroughs in medical products for cardioangioplasty and blood testing became the mainstays of the company, although the manufacture and sale of basic medical supplies continued.

Four years ago, Eagleman retired and appointed his nephew John Tillerman CEO. Tillerman took the company public (though *Wall Street Journal* readers have reported difficulties finding it listed on any exchange). Tillerman felt that high sales volume was the key to a successful company. Research and Development was important, but the focus was on sales. The company remained profitable because of sales of its existing products, but it was not creating new ones.

Unfortunately for Medtech, public pressure in the 1990s has forced the health care industry to shift from unlimited expansion to cost containment. Gov-

ernment agencies no longer automatically reimburses hospitals for large expenditures on medical equipment. Instead, a lengthy approval process is required. Fewer hospital admissions and shorter stays have cut the need for medical supplies, too. Medtech has been hit especially hard because hospitals were its primary customers. As Medtech's sales dropped, profits shrank, and Tillerman was forced out.

A year ago Evelyn Dupray became the new CEO. She says she wants to recapture the excitement that existed under Eagleman's leadership. She describes her vision of the future as "the Three T's:" Technology, Teams, and Transnational.

Technology

Dupray found Research and Development underfunded, underdeveloped and understaffed. Nevertheless, technological innovation is crucial to Medtech's new direction. Medtech has a device capable of removing plaque from clogged arteries already and is working on additional laser applications for use in eye surgery and various kinds of cancer treatment. Laser technology holds the promise of replacing many kinds of even more expensive surgery. Thus, it promises safer, cheaper medical care.

The first company able to get new products to market stands to receive hefty profits. Delays can be lethal in this competitive climate. High-tech products generally have profit margins of over 100%,

Exhibit 1
Customer Perceptions of Medtech's Quality

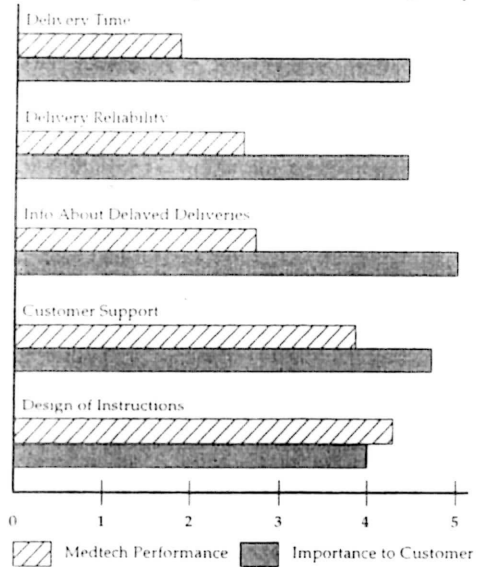
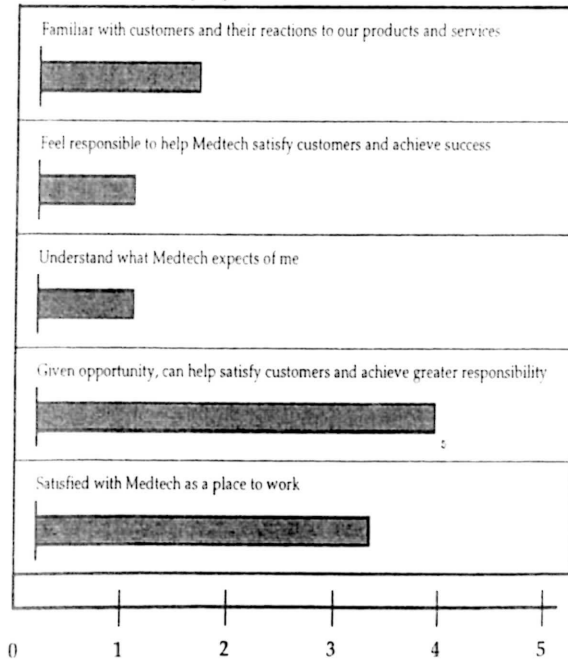


Exhibit 2
Employee Attitudes



while the bandages, sutures and such have profit margins of less than 20%.

Teams

Dupray also believes Medtech must get closer to its customers. Teams that include customers and suppliers will help Medtech create and deliver products, information, expertise and service.

Transnational

A good part of the industry's future growth will come outside the United States. As technology continues to improve and prices decrease, many international customers will be able to make purchases they could not afford in the past. Consequently, Dupray has given Medtech's initial forays into international markets a high priority. Marketing offices have been set up in Brussels, Madrid, and Tokyo. An alliance has been struck with a small medical engineering company in Spain. Medtech provides financial support and administrative expertise; the Spanish partner provides R&D for the European Community markets.

SURVEY RESULTS

In spite of her renewed spirit and emphasis on "the 3 T's", Dupray realizes that Medtech still suffers some underlying problems. In order to get a better handle on what's going on, she decided to examine the company from the perspective of its three key constituencies - customers, employees, and shareholders.

Customer Attitudes

A survey of Medtech's customers revealed that a number of large, profitable clients were so dissatisfied that Medtech was in danger of losing their accounts. Customer dissatisfaction seemed to stem from poor service, long delivery times, and an inability to meet customers' requirements for cutting-edge medical equipment (Exhibit 1). In addition, with the push to emphasize sales, Medtech was maintaining a number of customers who generated high transaction and service costs relative to purchases. These customers contribute little or nothing to Medtech's profits.

Employee Attitudes

Service quality depends on employees' behavior toward customers and employee

flexibility to respond to customer demands. Therefore, Ms. Dupray conducted surveys and focus groups to assess employee attitudes at the same time the customer satisfaction measurements were made. Core areas addressed were understanding Medtech's business, its goals and objectives, its products and services, clarity of work and job expectations, performance, and satisfaction with work. The results, shown in Exhibit 2, revealed weaknesses. For example, employees seemed to have an inadequate understanding of, and commitment to, the customer-ori-

ented goals of the firm. They complained of too little responsibility and accountability.

Additionally, employees in the focus group meetings stated that they really had no idea about why they were paid the way they were. They felt that the way to get a pay increase depended on inflation and living costs, plus their experience. Many mentioned that a big factor seemed to be who you worked for. Nevertheless, there is a sense of pride in Medtech and a substantial reservoir of good will and trust among employees.

MEDTECH INCOME STATEMENT

	2 Years Ago	1 Year Ago	Current
REVENUES			
Net Sales	\$ 72,441,553	\$ 75,701,423	\$ 80,297,240
Other Income	614,961	645,225	678,539
TOTAL REVENUE	\$ 73,056,514	\$ 76,346,648	\$ 80,975,779
EXPENSES			
Interest	\$ 2,541,645	\$ 2,474,146	\$ 2,404,736
Depreciation	2,138,540	2,245,467	2,346,513
Maintenance	6,974,386	7,484,174	8,052,165
Equipment and Materials	32,033,080	28,484,098	28,147,270
Salary & Benefit Expenses	20,938,236	26,758,562	30,854,284
TOTAL EXPENSES	\$64,625,887	\$67,446,447	\$ 71,804,968
Earnings Before Taxes	\$ 8,430,627	\$ 8,900,201	\$ 9,170,811
Provision for Income Taxes	2,107,657	2,225,050	2,292,703
NET INCOME	\$ 6,322,970	\$ 6,675,151	\$ 6,878,108
Common Shares Outstanding	1,500,000	1,500,000	1,500,000
NET EARNINGS PER SHARE	\$ 4.22	\$ 4.45	\$ 4.59
ACCUMULATED AND RETAINED EARNINGS			
Retained Earnings Jan. 1	\$ 19,745,315	\$ 23,868,285	\$ 28,343,436
Net Income	6,322,970	6,675,151	6,878,108
Total	26,068,285	30,543,436	35,221,544
Less Dividends Paid	2,200,000	2,200,000	2,200,000
Retained Earnings Dec. 31	23,868,285	28,343,436	33,021,544

Profitability

For the most part, the financial structure of Medtech has been relatively sound. Current sales are over \$80 million, a net increase of about 6 percent above that earned during the prior year. The financial information in Exhibit 3 highlights Medtech's finan-

cial progress. However, the ratios and the income statement and balance sheet reveal that labor costs have been increasing faster than revenues for the past two years. Labor costs are becoming a larger proportion of Medtech's total expenses. Medtech currently employs about 450 employees.

MEDTECH BALANCE SHEET

	2 Years Ago	1 Year Ago	Current
CURRENT ASSETS			
Cash	\$ 1,727,728	\$ 1,760,475	\$ 1,796,598
Inventory	3,415,338	3,569,029	3,738,558
Accounts Receivable	8,085,866	8,449,730	8,851,092
Other	1,557,337	1,627,418	1,704,720
Total Current Assets	\$14,786,269	\$15,406,652	\$16,090,968
FIXED ASSETS			
Investments	\$ 3,312,145	\$ 3,461,192	\$ 3,625,599
Plant & Equipment	44,909,339	46,930,260	49,159,447
Other	1,311,222	1,370,224	1,435,311
Total Fixed Assets	\$48,532,706	\$51,761,676	\$ 54,220,357
TOTAL ASSETS	\$63,318,975	\$67,168,328	\$ 70,311,325
CURRENT LIABILITIES			
Accounts Payable	\$ 2,036,796	\$ 2,308,451	\$ 2,608,103
Accrued Taxes	1,572,368	1,671,871	1,835,505
Accrued Payroll	688,764	726,674	768,043
Accrued Interest Payable	4,148,684	3,142,707	2,115,877
Other	1,442,343	1,507,249	1,578,843
Total Current Liabilities	\$ 9,888,955	\$ 9,356,952	\$ 8,906,371
LONG-TERM LIABILITIES	\$23,000,000	\$23,000,000	\$23,000,000
TOTAL LIABILITIES	\$32,888,955	\$32,356,952	\$31,906,371
EQUITY			
Common Stock	\$ 150,000	\$ 150,000	\$ 150,000
Capital in Excess of Par	6,411,735	6,317,940	5,233,410
Retained Earnings	23,868,285	28,343,436	33,021,544
TOTAL STOCKHOLDERS EQUITY	30,430,020	34,811,376	38,404,954
TOTAL LIABILITIES AND EQUITY	\$ 63,318,975	\$ 67,168,328	\$ 70,311,325

TODAY

As a result of their meetings, Dupray and her top leadership team have written a memo to employees outlining the company's new "Partnership for Success."

"The heart of this Partnership is the alliance among our customers, our suppliers, and all Medtech employees. Together, we can renew the spirit and enthusiasm that have served Medtech so well.

What does Medtech's Partnership for Success really mean? It means we will continuously strive to achieve seven objectives (shown on next page).

In order to achieve these objectives, we must produce innovative, high-quality products and services designed in collaboration with our customers and suppliers. Flatter hierarchies and increased use

of teams can help us reach these goals.

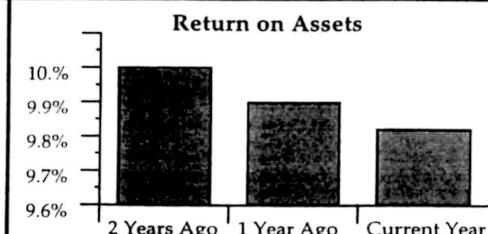
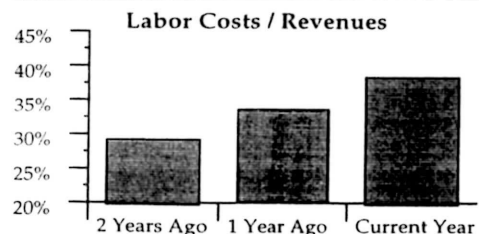
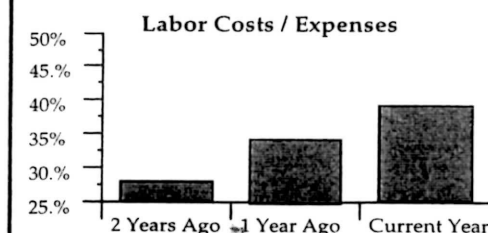
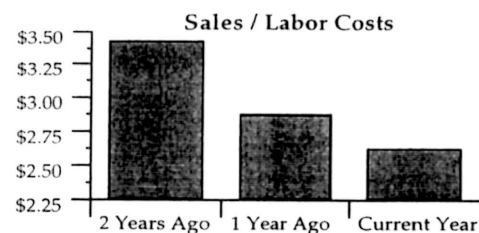
But individual employees remain the heart of Medtech. Each one of us makes a difference. Each one of us matters. Satisfying our customers, our shareholders, and ourselves are the fundamental keys to our success."

Strategic Perspectives

Medtech and its competitors seem to follow some combination of two basic strategies. Some compete by pursuing an innovation strategy: creating new medical devices that change the treatment or diagnosis of a disease. Others compete through a low-cost strategy: offering more efficient methods to manufacture or improve current equipment. Still others attempt to combine both approaches.

Exhibit 3
Labor Cost Ratios

	Sales/ Labor Costs	Labor Costs / Expenses	Labor Costs / Revenues	Return on Assets
2 Years Ago	\$3.46	32%	29%	10.0%
1 Year Ago	\$2.83	40%	35%	9.9%
Current Year	\$2.60	43%	38%	9.8%



RECOMMEND COMPENSATION OBJECTIVES

Now that you are familiar with Medtech, let us begin to design their compensation system. This initial exercise has three steps.

Step One:

Think about Medtech's present and future business environment. Be sure you consider what top executives say in the memo on the Partnership for Success. Based on this information, specify the company's business strategy.

Step Two:

Specify as best you can Medtech's Human Resource Management values and philosophy.

Step Three:

Recommend objectives for your compensation plan. Your objectives should cover

- Organization Performance (i.e., profitability, market share, return on assets);
- Cost Control;
- Desired Employee Work Attitudes and Behaviors; and
- Legal Compliance.

Demonstrate how the compensation objectives help support Medtech's business strategy, its vision, and its values. The objectives you propose will guide you as you design Medtech's pay system.

Medtech's Partnership for Success

1. *Emphasize innovation, risk-taking and creativity;*
2. *Achieve success through delivering solutions to customers; sustain success through emphasis on team work;*
3. *Stress flexibility and adaptability to change;*
4. *Underscore the importance of Engineering, R&D, Marketing, and Quality Manufacturing;*
5. *Achieve continual growth through creating new markets and improving quality;*
6. *Delight customers with exemplary service;*
7. *Treat all employees, customers, and suppliers with respect and fairness.*

PHASE I INTERNAL CONSISTENCY: DESIGNING AN INTERNAL STRUCTURE