Unit 5
Incentives & Benefits

Incentives

- **Incentives** refer to the **variable and performance-linked components of compensation** that are paid to employees in addition to their regular wages or salaries. Incentives are designed to **motivate employees to achieve higher levels of productivity, efficiency, quality, or performance.** Unlike fixed pay, incentives fluctuate based on individual, group, or organizational performance.
- Incentives act as a **stimulus or inducement** that encourages employees to put in extra effort, improve skills, and exceed standard performance expectations. They create a direct relationship between **effort, performance, and reward**, making compensation more dynamic and motivational.
- According to Milkovich and Newman, incentives are rewards that depend on **performance or results achieved**, rather than on job position or seniority alone.

Incentives

- **Incentives**
- Incentives are **variable components of compensation** paid in addition to basic wages or salary to motivate employees for **higher performance, productivity, efficiency, or achievement of specific targets**. Incentives are usually performance-linked and may be paid in **cash or non-cash form**.
- **Benefits**
- Benefits are **indirect forms of compensation** provided to employees to improve their **economic security, well-being, and quality of work life**. Benefits are generally not linked directly to performance and are often **statutory or long-term in nature**.

NATURE

- **Performance-Oriented**
  Incentives are closely linked to performance outcomes such as output, sales, profits, efficiency, or achievement of targets.
- **Variable in Nature**
  Incentive payments vary depending on results and are not guaranteed.
- **Motivational Tool**
  They act as a strong motivator by appealing to employees' economic and psychological needs.
- **Short-term or Long-term**
  Incentives may be short-term (monthly or annual bonuses) or long-term (ESOPs, stock grants).
- **Direct Financial Impact**
  Incentives usually involve monetary rewards, although non-monetary incentives also exist.

2. Objectives of Incentives & Benefits

- **2. Objectives of Incentives & Benefits**
- To **motivate employees** to perform better
- To attract and retain talented employees
- To align employee goals with organizational goals
- To improve productivity and efficiency
- To enhance employee satisfaction and morale
- To ensure social security and post-retirement safety

Incentives & Benefits

- Some of the non-financial incentives are good human relations, self-respect, recognition, status, sense of belonging, appreciation, higher responsibility, greater authority, job satisfaction, improved working conditions, greater leisure, etc. All these motivate workers to raise their productivity.
- ILO classifies incentive schemes into four categories: (i) schemes in which earnings vary in proportion to output, (ii) schemes where earnings vary proportionately less than output, (iii) schemes where earnings vary proportionately more than output, and (iv) schemes where earnings differ at different levels of output.
- Incentives have also been classified into individual, group and organisation-wide. In an individual incentive plan, the rewards of incentives are based solely on individual performance. It is the extra compensation paid to an individual over a specified amount for his production effort. Such a system is feasible only where an individual can increase the quantity and quality of his output by his own individual efforts and where his output can be measured. The payment is normally on a monthly basis, though in a few cases it may be quarterly or other convenient periods. The standards of performance have been set by a qualified industrial engineering analyst, using technically sound work measurement procedures. The rewards under this plan are almost always immediate, that is, paid daily or weekly.

Incentives & Benefits

- Incentives & Benefits Premium and differentials, pay for unit produced, individual based bonus and rewards, Designing a long term incentive and deferred compensation plan, Qualified deferred compensation arrangement, social security, retirement plan, pension plans, Performance based pay- types – profit sharing plan, stock bonus plan, ESOP ,employer benefits and employer costs for ESOP, Individual retirement account, Savings incentive match plan for employees. Valuing stock grants, SEBI Guidelines, taxability of stock options.
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advantages of group incentive plans

- Some of the advantages of group incentive plans are:
  - Better co-operation among workers
  - Less supervision
  - Reduced incidence of absenteeism
  - Reduced clerical work
  - Shorter training time.
- The disadvantages of group incentive plans are:
- An efficient worker may be penalised for the inefficiency of the other members in the group
- The incentive may not be strong enough to serve its purpose
- Rivalry among the members of the group defeats the very purpose of team work and co-operation.

The primary advantage of incentives is the inducement and motivation of workers for higher efficiency and greater output. It may not be difficult to get people for fixed wages and salaries. But with fixed remuneration, it is difficult to motivate workers to give better performance. Fixed remuneration removes fear of insecurity in the minds of employees.
Earnings of employees would be enhanced due to incentives. There are instances where incentive earnings exceed two to three times that of the time rated wages or salaries. Increased earnings would enable the employees to improve their standard of living.
There will be reduction in the total as well as per unit of cost of production through incentives. Productivity would increase resulting in greater number of units produced for given inputs. This would bring down the total and unit cost of production. The production capacity is also likely to increase.

One of the greatest difficulties with the incentive systems is in the setting of piece or bonus rates. Rate fixing involves delicate problems of judgment in which there is always a risk of error. If rates are set too low, workers are bound to be dissatisfied and will be under pressure to work very hard. If rates are set too high, workers may slacken their efforts at times and employers may not take recourse to revision of rates because the earnings are too high.

Difficulty also arises in determining standard performance. Many organisations follow a safe route to fix the standards - which is usually the average of past years performance. Past performance may not be the ideal basis for fixing production norms.

Most of the problems of financial incentives arise either from the inadequacies of the particular system or from incorrect application and insufficient control. In western countries, as also in India, it has now been realised that economic gain has ceased to be a source of motivation and that greater emphasis should be placed on non- economic factors. Many empirical researchers have shown that monetary incentives alone do not bring about the desired motivation.

PRE-REQUIS1TES OF EFFECTIVE INCENTIVE SCHEME

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Premiums and Differentials

- Premiums and differentials are important components of **incentive compensation**. They refer to **additional payments made over and above the basic wage or salary** to compensate employees for special working conditions, skills, effort, or inconvenience associated with a particular job. These payments help organizations maintain **fairness, motivation, and flexibility** in wage administration.
- In modern compensation systems, premiums and differentials are used to address variations in **time of work, working conditions, location, skills, and job demands**, ensuring that employees are adequately compensated for extra effort or hardship.
- Premiums and differentials refer to **additional payments** made over and above basic wages to compensate employees for **unfavorable working conditions, skills, timing, or location of work**.

Premiums and Differentials

- **Premiums**
- **Premiums** are additional monetary payments given to employees for performing work under **unusual, difficult, or undesirable conditions** or for working beyond normal working hours.
- Examples:
- Overtime premium
- Night shift premium
- Hazard premium
- **Differentials**
- **Differentials** refer to variations in wage rates paid to different employees or jobs based on **differences in skill, responsibility, location, time, or working conditions**.
- Examples:
- Skill differential
- Geographic wage differential
- Occupational differential

Objectives of Premiums and Differentials

- To compensate employees for **extra effort or inconvenience**
- To encourage acceptance of **difficult or unpopular work assignments**
- To ensure **internal equity** in wage structure
- To attract and retain employees for special skills or locations
- To motivate employees to work during odd hours or in risky conditions

Types of Premiums

- **1. Overtime Premium**
- Paid for work performed beyond normal working hours
- Usually calculated at **double or one-and-a-half times** the normal wage rate
- Regulated by labor laws
- **Purpose:**
  To compensate for fatigue and discourage excessive overtime.
- **4. Holiday and Weekend Premium**
- Paid for work on **public holidays or weekly offs**
- Encourages workforce availability during critical period

Types of Premiums

- **2. Shift Premium**
- Paid to employees working **night shifts or rotating shifts**
- Common in manufacturing, hospitals, and BPOs
- **Purpose:**
  To compensate for disturbance of normal biological and social life.
- **3. Hazard Premium**
- Paid for work involving **physical danger or health risks**
- Examples: mining, chemical plants, construction
- **Purpose:**
  To compensate for exposure to risk and ensure safety awareness.

Types of Premiums

- **Advantages**
- Simple and transparent compensation tool
- Improves acceptance of unfavorable working conditions
- Helps organizations remain competitive in labor markets

- **Limitations**
- Can increase labor costs
- Overuse may lead to wage inflation
- Difficult to standardize across jobs

Types of Differentials

- **Types of Differentials**
- **Shift Differential**
  - Extra pay for night shifts or rotating shifts.
  - Common in manufacturing, healthcare, BPOs.
- **Hazard Pay Differential**
  - Paid for dangerous or risky work conditions.
  - Example: mining, chemical plants.
- **Skill-Based Differential**
  - Additional pay for scarce or specialized skills.
- **Geographical Differential**
  - Compensates for high cost of living or remote locations.

Pay for Unit Produced (Piece Rate System)

- Pay is directly linked to the **number of units produced** rather than time spent.
- **Types**
- **Straight Piece Rate** – Fixed rate per unit
- **Differential Piece Rate** – Higher rate for higher output (Taylor, Merrick systems)
- **Advantages**
- Direct link between **performance and reward**
- Increases productivity
- Easy to understand
- **Advantages**
- Direct link between **performance and reward**
- Increases productivity
- Easy to understand

Pay for Unit Produced

- The **Pay for Unit Produced**, also known as the **Piece Rate System**, is a method of wage payment in which an employee is paid according to the **number of units produced or tasks completed**, rather than the time spent at work. This system directly links **wages to productivity**.
- Piece rate system is a wage payment method in which remuneration is based on the quantity of output produced by a worker during a given period.
- **Features**
- Payment is made per unit of output
- Emphasis on productivity and efficiency
- Wage rate is fixed per piece
- Commonly used in manufacturing and production in

Types of Piece Rate System

- **1. Straight Piece Rate System**
- Worker is paid a fixed rate for each unit produced.
- **Wages = Number of units × Rate per unit**
- Example: If rate = ₹10 per unit and output = 100 units
  → Wages = ₹1,000
- **2. Differential Piece Rate System**
- Different rates are paid for different levels of efficiency.
- Introduced by **F.W. Taylor**.
- Higher efficiency → higher piece rate
- Encourages employees to exceed standard performance.

Pay for Unit Produced

- **Advantages**
- Strong motivation to increase output
- Simple and easy to understand
- Direct relationship between effort and reward
- Lower supervision required
- Increased productivity reduces per-unit labor cost

- **Disadvantages**
- Quality of work may suffer due to speed
- Income insecurity for workers
- Not suitable where output is difficult to measure
- May encourage unhealthy competition
- Neglects teamwork

Individual-Based Bonus and Rewards

- **Individual-based bonus and rewards** are incentive schemes in which additional compensation is given to employees **based on their individual performance, contribution, or achievement**. These rewards are over and above regular salary and are designed to motivate employees to perform better.
- **Definition**
- *Individual-based bonuses and rewards are financial and non-financial incentives granted to employees in recognition of their personal performance and achievement.*

Objectives

- To motivate employees to improve performance
- To recognize and reward individual contribution
- To encourage accountability and excellence
- To attract and retain high-performing employees

Types of Individual-Based Bonuses and Rewards

- **1. Performance Bonus**
- Given for achieving or exceeding performance targets
- Common in sales, marketing, and production roles
- **2. Sales Commission**
- Paid as a percentage of sales generated
- Directly linked to individual effort
- **3. Spot Awards**
- Immediate rewards for exceptional performance
- Can be cash, vouchers, or gifts
- **4. Merit Pay**
- Salary increase based on performance appraisal
- Long-term impact on earnings
- **5. Non-Financial Rewards**
- Recognition certificates
- Employee of the Month
- Promotion opportunities
- Public appreciation

Types of Individual-Based Bonuses and Rewards

- **Advantages**
- Directly motivates individual performance
- Encourages responsibility and accountability
- Easy to link reward with results
- Improves productivity and efficiency
- Helps identify high performers

- **Disadvantages**
- May reduce teamwork and cooperation
- Can create unhealthy competition
- Possibility of bias in performance evaluation
- Focus on short-term results
- Stress and pressure on employees

Designing a Long-Term Incentive and Deferred Compensation Plan

- A **Long-Term Incentive Plan (LTIP)** and **Deferred Compensation Plan** are compensation strategies designed to reward employees for long-term performance and retain key talent by deferring a portion of compensation to a future date, usually linked to continued service or achievement of long-term goals.
- **Objectives of LTIP**
- Align employee interests with long-term organizational goals
- Retain key and high-potential employees
- Encourage sustained performance and commitment
- Promote ownership mentality among employees

Key Steps in Designing an LTIP

- **1. Identify Eligible Employees**
- Senior executives
- Key managerial personnel
- High-potential and critical skill employees

- **2. Define Performance Measures**
- Financial indicators (profit growth, ROE, EPS)
- Market-based indicators (share price, market share)
- Strategic goals (innovation, expansion)

Key Steps in Designing an LTIP

- **3. Select Type of Long-Term Incentives**
- Stock Options
- Restricted Stock Units (RSUs)
- Stock Appreciation Rights (SARs)
- Performance shares
- Cash-based long-term bonuses

- **4. Decide Vesting Period**
- Typically, 3–5 years
- Encourages employee retention

- **5. Determine Payout Structure**
- Fixed or performance-linked
- Partial or full vesting based on achievement

Deferred Compensation Plan

- A **Deferred Compensation Plan** allows employees to receive a portion of their compensation at a later date, often after retirement or completion of service.

- **Objectives**
- Employee retention
- Tax efficiency
- Retirement planning
- Long-term financial security

Benefits of Long-Term Incentive and Deferred Compensation Plans

- **For Employees**
- Long-term financial security
- Wealth creation
- Motivation and loyalty
- **For Employers**
- Retention of key talent
- Improved long-term performance
- Alignment of employee and organizational interests

Qualified Deferred Compensation Arrangement

- A **Qualified Deferred Compensation Arrangement** is a **legally approved retirement or savings plan** that allows employees to defer a portion of their earnings to a future date, usually after retirement. These plans are recognized by tax authorities and governed by statutory regulations, offering **tax benefits and financial security** to employees.

- **Definition**
- *A qualified deferred compensation arrangement is a compensation plan that meets statutory and tax regulations and provides employees with deferred income, typically for retirement, with tax advantages.*

Types of Qualified Deferred Compensation Arrangements

- **1. Provident Fund (PF)**
- Joint contribution by employer and employee
- Lump sum payment at retirement
- Tax benefits under Income Tax Act
- **2. Pension Plans**
- Provide regular income after retirement
- Can be defined benefit or defined contribution plans
- **3. Gratuity**
- Paid by employer after a minimum period of service
- Based on last drawn salary and years of service
- **4. Superannuation Fund**
- Employer-funded retirement benefit
- Paid as pension or lump sum

Performance-Based Pay

- **Performance-based pay** is a compensation system in which a part of an employee's earnings is **linked to performance outcomes** rather than fixed salary alone. It rewards employees based on individual, group, or organizational performance and encourages higher productivity and commitment.
- **Types of Performance-Based Pay**
- **1. Profit Sharing Plan**
- **Meaning**
- A **Profit Sharing Plan** is a system in which employees receive a **share of the organization's profits** in addition to their regular wages or salaries. The amount distributed depends on the company's overall profitability.

Performance-Based Pay

- **Objectives**
- Motivate employees to improve efficiency
- Promote a sense of ownership
- Encourage teamwork and cooperation
- Align employee and organizational goals
- **Advantages**
- Encourages collective effort
- Improves employee morale and loyalty
- Reduces industrial conflicts
- Flexible cost for employers

Limitations

- No reward if profits are low or absent
- Weak link between individual effort and reward
- Employees have little control over profits
- Delay in rewards may reduce motivation

Stock Bonus Plan

- A **Stock Bonus Plan** is a performance-based pay system in which employees are rewarded with **company shares instead of cash** as a bonus. It helps employees develop an ownership interest in the organization.
- **Features**
- Bonus paid in the form of shares
- Shares may be restricted or vested over time
- Long-term incentive in nature
- Common in large and listed companies
- **Objectives**
- Retain key employees
- Encourage long-term commitment
- Align employee interests with shareholders
- Promote wealth creation

Difference Between Profit Sharing and Stock Bonus Plans

Basis	Profit Sharing Plan	Stock Bonus Plan
Form of reward	Cash or deferred cash	Company shares
Basis	Organizational profits	Performance & ownership
Risk	Low	High (market risk)
Time horizon	Short-term	Long-term
Ownership	No ownership	Ownership interest

Employee Stock Option Plan

- An **Employee Stock Option Plan (ESOP)** is a long-term incentive scheme in which employees are given the **right (option) to purchase company shares at a predetermined price** after a specified vesting period. ESOPs aim to motivate employees, retain talent, and align employee interests with those of shareholders.
- **Features of ESOP**
- Option to buy shares at a fixed exercise price
- Vesting period before options can be exercised
- Linked to continued service and/or performance
- Regulated by SEBI guidelines (in India)
- Long-term incentive in nature

Employer Benefits of ESOP

- **Employee Retention**
  - Vesting period encourages employees to stay longer with the organization.
- **Motivation and Performance Improvement**
  - Employees work harder to increase company value and share price.
- **Alignment of Interests**
  - Aligns employee goals with shareholders' wealth maximization.
- **Attracting Talent**
  - Useful in attracting skilled employees, especially when cash compensation is limited.
- **Cash Flow Advantage**
  - Reduces immediate cash outflow compared to cash bonuses.
- **Enhanced Ownership Culture**
  - Employees feel a sense of ownership and responsibility.
- **Tax Benefits**
  - Certain tax deductions are available to employers on ESOP expenses.

Individual Retirement Account (IRA)

- An **Individual Retirement Account (IRA)** is a **personal retirement savings account** that allows individuals to save for retirement with **tax advantages**. It is maintained by the individual and not directly managed by the employer.

- **Objectives**
- To provide financial security after retirement
- To encourage long-term personal savings
- To offer tax benefits on retirement investments

Individual Retirement Account (IRA)

- **Features**
- Opened and owned by an individual
- Contributions may be tax-deductible (subject to rules)
- Funds grow over a long period
- Withdrawals are usually made after retirement
- **Advantages**
- Encourages retirement savings
- Tax benefits and compounding growth
- Individual control over investments

Savings Incentive Match Plan for Employees

- A **Savings Incentive Match Plan for Employees (SIMPLE)** is an **employer-sponsored retirement plan** designed mainly for **small organizations**, where employers match employee contributions.

- **Objectives**
- Encourage employee retirement savings
- Provide employer-supported retirement benefits
- Offer a simple and low-cost retirement plan

Savings Incentive Match Plan for Employees

- **Advantages**
- **For Employees**
- Guaranteed employer contribution
- Easy participation
- Encourages regular savings
- **For Employers**
- Low administrative cost
- Improves employee retention
- Tax-deductible contributions

Valuing Stock Grants

- **Stock grants** refer to shares awarded to employees as part of compensation (e.g., RSUs, ESOPs). **Valuation** determines the monetary value of these shares for accounting, taxation, and disclosure purposes.

- **Objectives of Valuation**
- To determine fair compensation cost
- To ensure transparency and compliance
- To calculate tax liability
- To support financial reporting

Securities and Exchange Board of India

- The **Securities and Exchange Board of India (SEBI)** regulates ESOPs and stock-based benefits to ensure **fairness, transparency, and protection of investor interests**.
- **Key SEBI Guidelines**
- **Eligibility**
  - Permanent employees, directors, and key managerial personnel
  - Independent directors generally excluded
- **Shareholder Approval**
  - Mandatory approval through a special resolution
- **Vesting Period**
  - Minimum vesting period of **one year**
- **Pricing**
  - Exercise price decided by the company
  - Must be disclosed clearly

Taxability of Stock Options

- **Importance of SEBI Guidelines**
- Prevents misuse of ESOPs
- Ensures transparency and accountability
- Protects employee and investor interests

- **Impact of Taxability**
- Reduces net benefit to employees
- Influences employee participation in ESOPs
- Important for financial planning