SCHUSTER-ZINGHEIM
and associates, inc.
E-MAIL sz@schuster-zingheim.com • PHONE 310 471-4865 • WEB SITE www.paypeopleright.com

LINKING QUALITY AND PAY

Patricia K. Zingheim and Jay R. Schuster

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Traditional pay based on tenure, entitlement and bureaucratic organizational structure is not compatible with business and human resource challenges of the 1990s.

Today it is essential to link pay to measures of quality and customer value.

Many TQM champions believe strongly that total quality management (TQM) and an organization's financial performance are related. They contend that time and effort expended on improved quality and attention to the customer goes directly to their bottom line. We believe pay can complement and strengthen TQM and continuous improvement efforts.

GROUP VARIABLE PAY

The linkage between pay and quality can best be accomplished through the use of group variable pay—a cash award for meeting or exceeding goals based on the collaborative performance of a group of employees. These awards granted for results achieved are not folded into base salary. Some reasons we believe variable-pay is the only viable reward for quality are as follows:

Quality is a team sport. Improvements in quality depend on collaboration. Employees join together to attain mutual goals by exchanging ideas, sharing resources and information, problem solving and helping each other succeed. Only rewards that acknowledge cooperation rather than competition are consistent with TQM. Even when merit-based pay plans and individual incentives work well, they only focus on the individual and not on the team or group.

Quality is a win-win affair. The goal of TQM is continuous improvement on a wide range of measures. These multiple goals and measures include product and service quality, customer satisfaction, income performance, cost management and productivity to name a few. The results of satisfactory performance at the team, group and organizational level are shared with employees. Group variable pay combines the advantages of flexibility and shared rewards, a combination not available from individual rewards.

Continuous Improvement means change. Variable pay avoids becoming an annuity to the employee. As businesses' needs change, variable pay programs can communicate that change by focusing on new and/or improved measures of success. Meaningful rewards based on achievements can go to one group in one performance period and another in a subsequent performance period. Rewards can acknowledge performance improvement and success on various quality measures and goals.

Those who argue against linking pay to quality focus primarily on individual pay. We agree that there is no practical way to measure and reward quality results and outcomes on an individual employee basis.

Recent research suggests that organizations with an orientation toward rewarding employee performance are also likely to be TQM organizations.[1] The team nature of the quality movement requires team rather than individual rewards. Group variable pay offers opportunities to match pay to the tasks to be performed. The quality-pay linkage seems reasonable and sustainable.

Exhibit 1

WHY GROUP VARIABLE PAY IS THE BEST WAY TO LINK PAY TO QUALITY

GROUP VARIABLE PAY	INDIVIDUAL MERIT PAY
• Rewards teamwork and collaboration.	• Can create internal competition for pay raises.
• Encourages communication.	• Can encourage withholding of information.
• Encourages group to improve systems.	• Encourages individuals to try to improve systems on their own, which is very difficult to accomplish.
• Makes meaningful quality outcome measures the group measures.	• Uses individual quality outcome measures, which are difficult to develop meaningfully.
• Encourages focus on "bigger picture."	• Encourages micro focus.
• Increases flexibility; ability to respond to changing needs.	• Decreases flexibility.
• Requires re-earning each performance period.	• Becomes an annuity.

THE PAY-TQM PARTNERSHIP

TQM requires that an organization form partnerships with its customers and suppliers. It is unlikely that such partnerships can be formed unless one is formed between the organization and its employees. Because the relationship between an organization and its customers and suppliers is economic, it is reasonable to assume at least one objective of TQM is economic. One link between employees and their organization is pay for skills and job performance. Associating the economic link employees have with their organization—pay—with TQM is essential.

Determining a practical way to measure quality lies within TQM and continuous improvement efforts. With a focus on continuous improvement, the organization can apply quality measures to the pay-determination process early in the TQM process. This can occur considerably before highly refined measures and goals are available, using the best yardsticks available with the understanding that measurement will be improved based on experience with TQM. Measures may not be "ideal," but will improve as you go. This permits the early introduction of important priorities in the reward system, acknowledges that these measures and goals can be refined, and focuses on quality among other key organizational priorities.

Purists may say that exact measures are needed for a pay system to be credible. We believe TQM is an adventure in trust building. Entire organizations undertake major initiatives in hopes of improvement and enrichment. Much of the journey is "clarified as they go." Rewards are essential, because they necessitate continuous measurement improvements. If rewards such as pay are ignored until "TQM is a reality," the chance of ever linking pay to TQM may be lost. Measurement of TQM outcomes and the linkage to pay should grow together. Unless they do, pay may not be a partner to TQM.

For example, "MajorElectCorp" (MEG) is a large electronics manufacturer that undertook TQM in 1989. At the same time, they implemented group variable pay to focus on select measures of organizational success. The consultant retained to "install the TQM program" convinced the CEO to exclude quality measures from group variable pay. The argument was that quality measures "were not ready." Variable pay proceeded with measures of productivity, cost management and income.

What was the result? Continuous improvement worked. MEC substantially improved its ability to measure and focus employees on productivity, cost management and income. The move to group variable pay improved the line of sight of productivity, cost management and income measures for employee teams. Group variable pay was successful.

However, TQM struggled because what gets measured gets attention, and the group-reward system ignored quality measures. At MEC the pay system worked against the TQM process. The roles that pay and TQM play in organizational success remain in conflict. Waiting for the ideal measures defers a focus on key priorities. Early emphasis on quality measures and improving "as you go" encourages timely concern about how to convert "process-only" TQM approaches to those that generate measurable outcomes and results.

From the start, organizations should apply to pay the best possible quality measures, comparable to the measures for productivity, cost management and the like. Measures worth considering include the following:

Customer value and satisfaction. This is a TQM linkage that provides information on how the organization is doing based on data from those who exchange information and experiences inside and outside the organization.

- *Retention of customers.* The measurement of defections of valued customers keeps a focus on sustaining effective relationships. Obtaining new customers is more expensive than keeping existing, profitable ones. In fact, profits in service organizations can increase significantly by reducing customer loss, because existing customers tend to increase purchases, minimize operating cost, provide referrals and allow for pricing premiums.[2] Some organizations believe that the voluntary termination of top-performing employees with "hard-to-recruit" skills is a measure of internal customer defections.

- *External customer satisfaction.* Evaluating performance from the external customer standpoint and measuring the relative change through surveys provide important information. Customer satisfaction is compared to customer satisfaction with competitors. External customer satisfaction is an element of continuous improvement strategy that relates to sales, market share and other bottom-line goals.

- *Internal customer satisfaction.* When TQM involves creating work teams and moving information and accountability to lower levels in the organization, the success and speed of these changes are worthy quality measures. Change is often based on expanding: employee involvement and participation. In addition, staff employees function as collaborators, advisors and facilitators for line employees rather than blockers and regulators.[3]

Quality of product or service. The evaluation of products and services is a critical linkage that affects results such as bottom line, market share, sales and customer defection. The issue is that the customer gets the best products, services and value for the dollars expended.

- *Delivery time.* In an age of just-in-time and minimum inventory, getting what customers need to them when they need it is essential. This measurement will often track changes in the time it takes to respond to customers.

- *Recovery from failure.* When thing are not what they should be, recovery measures evaluate whether the organization "takes the customer to lunch" to "make problems disappear" or actually addresses the challenge without excuses. In addition to minimizing error, organizations focus on follow-up to "fix it," because customers usually have higher expectations for recovery service than for service in general.

- *Reliability and consistency.* Much of TQM depends on high quality that can be counted upon. Reliability has been shown to be the most important service dimension in service organizations.[4] Making frequent errors and routinely breaking promises to customers reduces customer confidence and can ultimately cause customer defection. Measures include frequency and types of errors, failures, breakdowns, promises not kept (or, conversely, the error-free rate) and number of customers affected.

- *Rework and rejects.* This measures how many times it takes to do it right and the cost of having to do something several times to get it right. Measures involve scrap, wasted labor cost, material inefficiency and other costs that increase product and service expense and reduce profits.

- *Warranties and adjustments.* Decreases in warranty expense can be due to quality increases in the design and development stage or in the production stage. Warranty expenses and adjustments to billing necessitated by poor quality are a concern, not only because of the associated cost but also because of the reduced satisfaction of external customers who received the poor-quality product or service.

This partial list shows that quality measures linked with group variable pay can be important to TQM.

REAPING REWARDS

Quality-based measures can affect awards within group-variable-pay plans.

Fund an award. Quality results and outcomes "fund" a part of the group-variable-pay award independently and in addition to other funding measures and goals. Awards increase as the organization enjoys the benefits of quality.

Modify an award. Group-variable-pay awards are funded by one or more measures such as bottom line and productivity. Quality results serve to multiply and/or reduce the award generated from other measures.

Qualify an award. A defined level of quality is needed: one, for other measures and goals to generate an award or, two, for some part of an award based on achievement of other goals to be made available to employees. Quality serves as a "gate" that must be passed to make available part or all of an award generated from other measures and goals.

Measures of quality outcomes and results can play the same roles that other measures and goals play in group variable pay. The chosen role is based on the message the organization wants to communicate and the measures used. In the examples that follow, assume all organizations have determined that linking group variable pay to TQM outcomes and results is important.

"QualFundCorp" (QFC), a custom electronic components manufacturer, has established a direct relationship between customer retention and bottom-line results. QFC has a "winsharing" group-variable-pay plan. *Winsharing* means the organization's bottom line—in contrast to only productivity, cost management, etc.—plays a central role as a variable pay measure. The plan has quality measurements that function independently in determining whether funds are made available for variable pay awards. The QFC plan funds awards partly based on operating income above budget, because the employees should understand the customer connection—that customers have to want to buy the product at a certain price—for both QFC and employees to "win."

A second measure is that warranty expense be less than a targeted percentage of revenues; a third is customer retention. These last two measures help group variable pay at QFC communicate how to achieve the bottom-line measure, because they correlate with and support the bottom line.

These three measures function independently in generating awards under the winsharing plan. Partial funding of group variable pay will occur if one or more of the performance requirements is achieved. The "funder" award approach matches the design goal of providing funding of part of the group-variable-pay plan even if one or two of the measures are missed. For example, if quality goals are made—which the employees can more easily influence—some funds will be available.

"QualModifierCorp" (QMC) is a health insurance company. Its business-plan-gainsharing plan is based on strategic measures specific to the organization's business and financial plan but excludes one measure, the bottom line of the organization. Measures that support the containment of expenses are used to generate part of the group-variable-pay funding, since QMC does not want to base awards on income, which is affected by the amount of claims paid. Quality results, in terms of customer satisfaction surveys of policyholders and health-care providers, can increase or decrease the variable pay dollars generated from other goals.

At QMC, 25 percent of the funding comes from achieving the target on an index that includes such measures as timeliness and accuracy, 25 percent from achieving volume goals (number of policyholder contracts), 25 percent from expense control, and the remaining 25 percent from a productivity goal. If surveyed customer satisfaction increases above a targeted level, the award based on the other four measures is magnified. If customer satisfaction is less than targeted performance, the award is decreased. QMC uses a performance scale that relates customer satisfaction scores to a formula for modifying group-variable-pay awards.

At QMC, customer satisfaction modifies the award both up and down. Other approaches modify the award only one way—either up or down, depending on the measure and the message to be communicated. With quality as a modifier, its emphasis can vary in magnitude, affecting how much the award increases or decreases for a specific level of change in the quality measure. In contrast to the first design model of quality as a funder, a quality-modifier design does not call for the quality measure to independently fund an award. If there is no award based on achievement of other measures, quality performance alone cannot generate an award.

"QualPartialCorp" (QPC), a medical equipment manufacturer, starts with a conventional gainsharing plan based on cost control and unit productivity. The gainsharing plan is not related to the overall financial performance of QPC. Its group-variable-pay awards are based on cost control and productivity, even though these results may occur in a year in which QPC does not meet bottom-line goals. The QPC plan funds awards based on expense-related gain.

QPC diverges from traditional gainsharing by requiring additional performance that focuses employees on key quality directions if awards based on gain are to be granted. Half of the employees' share of the gain achieved from reduced cost and improved productivity at QPC is automatically earned by employees. Another 25 percent of the employees' share of the gain is earned if the target of customer-satisfaction surveys is achieved, and the remaining 25 percent is earned if quality defect performance, picked up at the customer user level, is at or better than target level.

The partial-qualifier design makes dollars available for awards based on either an expense or bottom-line measure or some other measure(s). However, quality goals must be achieved to earn part of the award. In contrast to the previous two designs of quality funders and modifiers, the partial-qualifier design does not provide added funding in the event of quality performance beyond a specific level.

"QualMinimumQualCorp" (QMQC) is a hospital with a group-variable-pay plan combining cost control and bottom line. The plan shares a percentage of the savings based on containing expenses relative to a flexible budget; the percentage of savings shared with employees increases as bottom-line results improve. This means that both cost and income are considered. Department-level quality measures, including clinical quality indicators or internal customer satisfaction surveys provide a "gate" that must be passed for any group-variable-pay dollars to be available to employees.

This minimum-qualifier design sets go-no go quality standards that must be passed before any awards occur. This is different from the previous partial-qualifier design in which some award is earned based on achievement of other goals, regardless of quality performance. However, like the partial-qualifier design, the minimum-qualifier design does not provide added funding in the event of quality performance beyond a specific level.

Organizations normally develop strategies for total compensation (base pay, variable pay and benefits) in general and specifically for group variable pay. Based on this, they select and include TQM outcome measures. Subsequently, measures are refined and improved as group variable pay is continually evaluated and modified to make sure the communications and measurement message accurately reflects the organization's directions.

THE IDEAL TOOL

The momentum is clearly on the side of change for pay systems and for alignment of pay with strategic organizational priorities such as TQM. It makes sense to have pay help communicate the goals and measures that are needed to help make TQM important. Group variable pay is the ideal tool because of its flexibility, ability to respond to multiple goals and measures, and encouragement of collaboration and teamwork.

"Organizations and how they perform have changed measurably since the 1940s. ...Organizations cling religiously to outmoded pay ... programs. If they were so grounded in other business systems that were accepted in the 1940s, it is likely they would still be using manual typewriters with carbon paper and pocket slide rules and viewing them as contemporary business equipment"[5] Clearly, the time for change is now.

NOTES

1. Edward E. Lawler III, Susan A. Mohrman, and Gerald E. Ledford Jr, *Employee Involvement in Total Quality Management* (San Francisco: Jossey-Bass, 1992).
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3. David E. Bowen and Edward E. Lawler III, "Total Quality-Oriented Human Resources Management," *Organizational Dynamics*, (Spring 1992), pp. 29-41.
4. Leonard L. Berry and A. Parasuraman, "Prescriptions for a Service Quality Revolution in America," *Organizational Dynamics*, (Spring 1992), pp. 5-15.
5. Jay R. Schuster and Patricia K. Zingheim, *The New Pay: Linking Employee and Organizational Performance* (New York: Lexington Books/Macmillan, 1992).

Patricia K. Zingheim and Jay R. Schuster are partners in Schuster-Zingheim and Associates, Inc., a pay and rewards consulting firm in Los Angeles (310-471-4865). They are recipients of WorldatWork's 2006 Keystone Award, the highest honor in the total rewards profession. They are the authors of two books, *Pay People Right!* (Jossey-Bass Publishers) and *The New Pay*. Their Website is www.paypeopleright.com.