Optimal Compensation: Rebalancing Pay

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Abstract

A number of researchers have examined organizations progress through various stages in a life cycle as they grow and develop from birth to death. This article explains organizational life cycle (OLC), its impact on organization performance, and response of human resources (HR) manager for effective compensation management with specific reference to Indian Small and Medium Enterprises (SMEs). SMEs have distinct stages of OLC i.e. introduction, growth, maturity and decline. Organization's characteristics, response and resource requirements are quite different in each stage of OLC. Rebalancing fixed and variable pay in compensation structure according to different stages of OLC will help organizations in designing optimal compensation strategy for building competitive advantage.

Key words:

Compensation Management, Fixed Pay, Variable Pay, SMEs, Organizational Life Cycle.

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Life cycle is perhaps one of the most used theories of development and change in the management literature. A number of researchers have proposed that organizations progress through various stages in a life cycle as they grow and develop from birth to death (Mintzberg, 1984). The concept of the organizational life cycle (OLC) has developed to explain changes taking place in an organization over time. The stage in the life cycle is likely to be a key determinant of compensation strategies and their effectiveness in achieving organizational goals (Balkin *et al.*, 1987). The primary objective of this paper is to propose a framework for selecting appropriate compensation plan according to different stages of OLC with specific reference to Indian Small and Medium Enterprises (SMEs). When organizations think of motivating employees, they think of ways to reward their perfor-mance through an appropriate compensation strategy. Compensation comprises two core elements - fixed pay and variable pay, as explained below (Madhani, 2010):

1. Fixed pay is fixed in nature and does not vary according to performance or results achieved. Fixed pay compensation is usually determined by the

organization's overall pay philosophy and compensation structure.

2. Variable pay, also known as pay at risk, changes directly with the level of performance or results achieved. Variable compensation is a one-time earning that must be re-established and re-earned each performance period.

OLC: An Introduction

The organizations, like all living organisms, have a well defined life cycle and undergo very predictable and repetitive patterns of behaviour as they grow and develop (Adizes, 1979). The life cycle analogy borrowed from biological science is developed in order to depict the development and growth of organizations over time (Lodahl and Mitchell, 1980). The adaptation of the concept of a biological life cycle by researchers is not quite new. Like people and plants, organizations have a life cycle and may go from youth to old age in two or three decades, or it may last for centuries (Gardener, 1965). Organizations move from one stage to another, because the fit between the organization and its environment is so inadequate that either the organization's efficiency and/or effectiveness is seriously impaired or its survival is threatened if it does not change (Baird and Meshoulam, 1988). As large number of strategically significant environmental and organizational variables affects organization performance, opportunities and threats in the external and internal environment of an organization vary considerably with life cycle stages (Anderson, and Zeithaml, 1984). Organizations are likely to have different needs, in different stages of the OLC.

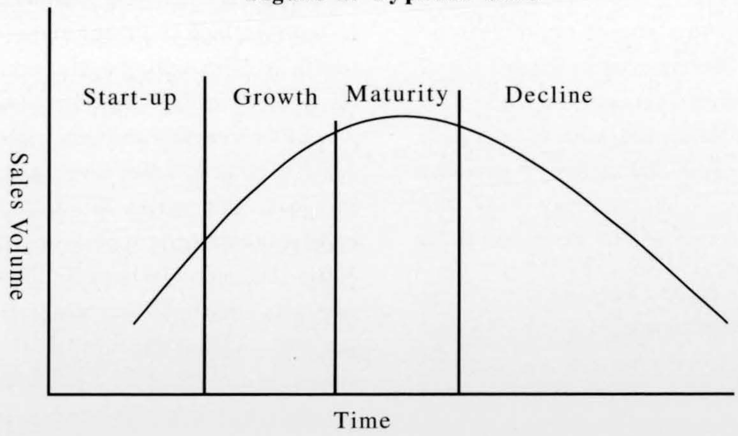
To better articulate this organizational life, the whole has been broken down into steps or stages. The OLC depicts that the process of organizational growth and development goes through a few regular stages (Gupta and Chin, 1994). Borrowing a universally accepted concept from the biological sciences, management researchers have developed various models to depict the life cycle of organizations (Lodahl and Mitchell, 1980). It is proposed that organizations, like civilizations, are born, grow, and eventually face stage of either decline or realign (Toynbee, 1957). There are a great number of multi-stage organizational life cycle models that focus on a diverse array of characteristics to describe organizational development (Granlund and Taipaleenmaki, 2005) and vary widely in a number of ways, including features and the actual number of stages (Jawahar and McLaughlin, 2001). The OLC stages vary per model depending on how the researcher defines an actual stage. Because the definitions vary, authors differed about the number of stages of the life cycle, hence most of these models are multi-stage in nature, ranging from three to ten stages, and portray a similar pattern of development of organizations.

Many models of OLC have been proposed, each of which emphasizes different factors to explain the changing characteristics of organizations over time. Some researchers proposed three-stage models (*Lippitt and Schmidt*, 1967) while other management researchers believed there should be four (Lyden, 1975), five (Greiner, 1972), nine (Torbert, 1974), or ten stages (Adizes, 2004). Whether the model is three or ten stages, most researchers are trying to describe a similar pattern of growth and development. Larger models tend to break down general stages into much more specific time periods, while shorter models tend to over generalize, incorporating two or more developmental periods in an effort to present a more straightforward depiction of organizational life (Lester and Parnell, 2005). However, what is important is that, regardless of the numbers, OLC stages are: (i) sequential in nature; (ii) each stage is a result of the previous one and occurs as a hierarchical progression that is not easily reversed; and (iii) involve a broad range of contextual organizational activities, characteristics and structures (Lavoie and Culbert, 1978). The OLC models claim that all firms pass through predictable stages of growth and that their strategies, structures, and activities correspond to their stage of development. The values of life cycle models lie in their acknowledgment of the dynamic and evolutionary nature of organizations as they develop. Different organizational researchers stressed a unique set of characteristics and challenges found in each stage of their OLC models. While some researchers question validity of the OLC concept by stating that biological analogies contribute little to the theory of growth and development of organizations (Penrose, 1952), its applicability has been confirmed by various empirical research (Smith *et al.,* 1985).

Different Stages of OLC: Main Features

The concept of the life cycle is obvious, as organizations are at some point born (Tichy, 1980), attempt to grow to one size or another and in different forms (Mintzberg, 1989), and ultimately they all die. The theoretical view of the OLC concept is clearly deterministic, with an evolutionary perspective that organizations passes distinctly from one stage to the next over time. Most organizations do not pass inexorably from one stage to another stage of growth in the traditional biological sense (Lester and Parnell, 2002). However, organizations may go through the stages in different sequences. For example, the maturity phase may be followed by decline, revival, or even growth; growth may be followed by maturity or decline; revival may precede or follow decline and so on. Clearly, there are a large number of transitional paths available to organizations. Hence, there may be no commonly accepted OLC, but there are indeed regular life cycle stages which differ largely but consistently from one another and which covers a very large portion of organizations (Miller and Friesen, 1984). While the stages of the OLC are internally coherent and very different from one another they are by no means linked to each other in any deterministic path. Life cycle stages are defined as a unique configuration of variables related to organization context, strategy, and structure (Hanks, 1990). There are four key stages of the OLC, start-up, growth, maturity and decline (Kimberly and Miles, 1980); the latter may transfer into revival. The typical OLC is shown in Figure 1 and its main stages are described below:

Figure 1: Typical OLC



(Source: Chart developed by author)

Start-up Stage

The first stage of OLC, start-up, or inception stage occurs when an organization begins its operation from a few products. Start-up stage also known as birth stage, shows small and young, organization trying to establish a niche for them and is typically with little or no formal structure. In the start-up stage, organizations will have trouble finding and selecting adequate and suitable employees because prospective employees do not view the organization as viable or legitimate (Williamson, 2000). New ventures in start-up stage have limited capital available to invest in attracting good sales people as organizations face strong cash demands to finance capital expansion. Here, the firm's cash flow is negative as it pours cash into its investment. The firm in this stage is still small, short of capital, does not have extensive reserves, and is therefore vulnerable to financial shocks (Marshall and Heffes, 2004).

Growth Stage

The second stage of life cycle known as growth stage is characterized by rapidly growing organizations, expanding their niche in the market. Once the firm survives the trials and tribulations of start-up stage it enters in growth stage. By this stage, the organization has achieved a degree of success; the previously main concern for survival has largely been overcome, and the organization is actively involved in exploiting expansion opportunities. During the growth stage, organization focuses on selling, for increasing product demand and market share in the market. Large new investment is likely in this period. During this stage, the organization is growing in products, customers, sales volumes, geographic contact and in the number of employees giving rise to a hierarchical structure and functional specialization in which sales employees' roles are more differentiated from one another. In this stage, the organizational size and complexity increase obviously, so an organization needs multifaceted, versatile, and high performance sales people (Chen and Hsieh, 2005), to face a more competitive environment.

Maturity Stage

The maturity stage is the relatively flat period of life cycle that follows the rapid growth period. An organization at the maturity stage of the life cycle is experiencing slower but more consistent growth in its market. Firms entering in this stage are operationally successful, financially strong, and highly liquid and have stability and efficiency as their goal. As organizations mature, they focus more on defending their existing product niches. In the maturity stage, products and services start to lose their advantage, competition intensifies, and profit margins erode. In this stage, organizations emphasize retaining customers, serving existing segments, and increasing the efficiency and effectiveness of the workforce. During this period, the organization has achieved greatest economies of scale in its life cycle and is able to generate steady and predictable profits. In the maturity stage, the environment becomes more stable and predictable in comparison with the growth stage.

Decline Stage

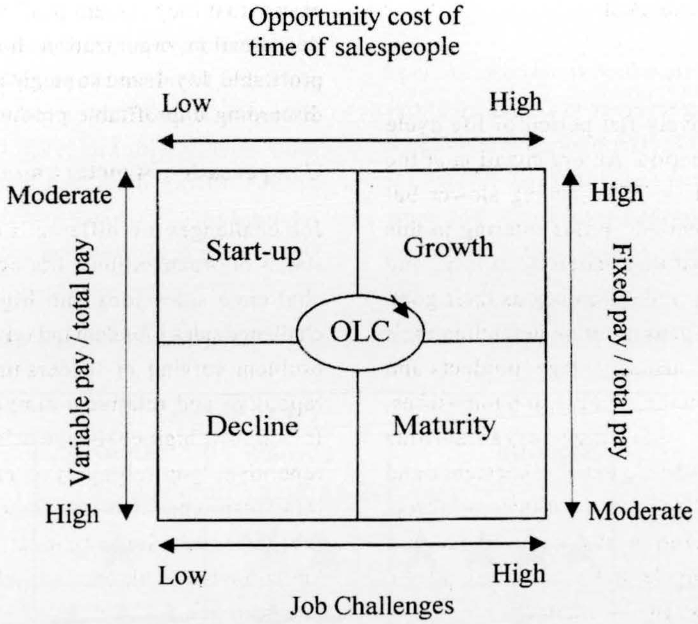
Although, the maturity stage can be extended through proper management action, internal and external factors or both may force the organization at any time to enter the decline stage (Whetten, 1980). During this stage organization begins to stagnate as markets dry up and product demands decrease. Decline stage results either in the organization's death or in a new organizational life by triggering a renewal stage. By this way, if the organization is capable of reorganization and total renewal, it may survive and continue to exist. However, if old organizational practice prevails, and organizational changes fail, it will eventually die. The decline stage of the OLC is characterized by a decrease in organization's resource base. In this stage, organizations are experiencing reductions in market share, reduced product demand and even financial losses, due to variety of reasons such as ineffective management practices, change in market environment or stiff competition etc. At this stage, organizations' strategies emphasize retaining and serving existing customers and segments. Some of the most obvious signs of decline stage include: declining sales relative to competitors, disappearing profit margins, and debt loads which continue to grow year after year. When a renewal or revival of organization is not likely and further decline is inevitable, organizations can only ensure that they remain profitable for as long as possible. In this situation, organization should focus on to serve the most profitable, loyal, and strategically important customers, while discarding unprofitable product line or territory.

Compensation Structure and Job Challenges during OLC

Job challenges are different for salespeople during different stages of organizational life cycle, and can be divided in low challenge sales jobs and high challenge sales jobs. Low challenge sales jobs demand relatively little degree of expertise, problem solving or leadership skills and typically involve repetitive and relatively simple sales process to customers. In contrast, high challenge sales jobs comprise complex, no-repetitive, long selling cycle and involve consultative role of relationship management for sales accounts. High challenge jobs differ from low-challenge jobs in their required degree of know-how, and higher level skills such as problem solving, and leadership skills. Similarly, high challenge sales jobs involve incremental supervisory responsibilities (Davenport, 2001). The more challenging the sales job the more valuable and noticeable is the contribution of sales people who do the job well. The opportunity cost of time of a sales person dealing with high skilled job is also likely to increase as the job challenge increases because of the increasing scarcity of these higher level skills. Organization will award higher percentage of fixed pay in compensation structure as job challenge rises. This relationship is shown in Figure 2.

Hence, for more challenging jobs where sales performances become difficult to observe, organizations rely proportionately less on variable pay and more fixed pay (Rouziès *et al.,* 2009). The ratio of fixed pay to total pay rises with an increase in the salesperson's opportunity cost of time. Moreover, if the organization does not reward them sufficiently for their efforts or pay below their 'opportunity cost of time,' competitors will poach the best performers in the organization. According to agency-theoretic perspective, it means not only a higher overall level of pay as job challenge rises but also a lower level of variable pay (Misra *et al.,* 2005). The proportion of variable pay in total pay of a sales person is likely to decrease as the job challenge of a sales person increases because of the increasing difficulty of replacing the sales person (George and Weitz, 1989). Hence, the greater the job challenge, the lower is the ratio of variable

Figure 2: Relationship between Compensation Structure and Job Challenges during OLC



(Source: Matrix developed by author)

to fixed pay for a salesperson. Job challenges and requirement of the selling efforts shift during different stages of organizational life cycle.

During start up stage, salespeople focus efforts on persuading customers to buy the organization's product. As job challenges and complexity are less, more variable pay in compensation structure is advocated. During growth stage, salespeople need to represent multiple products or markets. In the growth stage of OLC, there is increasing complexity in terms of selling task, management structure, product/markets, and geographic dispersion. As a result, incentive systems become more difficult to design, implement, and control. Ensuring non-contingent rewards for conducting a highly skilled and difficult task of selling new product or acquiring new customers and territories is necessary to attract and retain qualified sales people in challenging job environment. In such a case, as the role of sales people is more differentiated, a relatively higher proportion of fixed pay in the compensation structure would motivate the salespeople. To maintain market share during maturity stage, salesforce require high level of skills and efforts. Thus, during growth and maturity stage, higher proportion of fixed pay is advocated. During decline stage, sales person's role is focused on maintaining established profitable sales accounts. As this role is less difficult, the opportunity cost of time for the salesforce is also likely to decrease. Hence, to minimize increased business risk during such period, organizations must reduce commitment to fixed pay and maximize the use of variable pay.

Business Risk, Free Cash Flow and Operating Leverage during OLC

Business risk is defined as the risk inherent in the firm, independent of the way it is financed (Van Horne and Wachowicz, 2008). It is affected by various factors such as higher fixed cost structure, intensity of competition, growth prospects, and the variability of demand. A high (low) coefficient of variation of net operating income, for example, would indicate high (low) business risk. Business risk is greatly influenced by the amount of fixed costs used in a firm's operation. Generally, the greater the reliance on fixed costs, the lower the variable costs and vice versa. Business risk is the uncertainty associated with organization's operating environment and reflected in the variations of operating income and hence, having a negative impact on the profitability of a given organization.

Operating leverage is the extent to which fixed costs are used in a firm's operations. Operating leverage is a measure of risk and opportunity (Madhani, 2009). The operating leverage is a function of organization's cost structure, and defines the relationship between fixed costs and total costs. The more operating leverage (fixed costs / total costs), the more operating income will vary with changing sales revenues. Free cash flow is defined as cash in excess of that required funding all positive net present value projects (Jensen, 1986). It is cash flow beyond what is necessary to maintain assets in place and to finance expected new investments (Richardson, 2006). Free cash flow measures ease with organization can grow. A firm with high cash flow and profitable investment opportunities does not generate free cash flow. The relationship of business risk, operating leverage and free cash flow during organizational life cycle is given in Table 1.

Table 1: Business Risk, Free Cash Flow and Operating Leverage during OLC

OLC Features	OLC Stages			
	Start-up	***Growth***	***Maturity***	***Decline***
		Magnitude / Emphasis		
Business Risk	★★★★	★★	★	
Business Risk	⯨	★★	★★★	★
Opening Leverage	★	★★★	★★	⯨

(Source : Table compiled by author)

Start-up and Decline Stages

During start-up stage of OLC, business risk is very high and organization will face many external uncertainties such as the inability of an organization to predict future events, the volatility in an unfamiliar market, for example, the product demand, the strategies of competitor, etc. The compensation systems at the start-up stage emphasize individual-based incentive policies, as there are only few products or salespeople in the market place making a case for high variable pay in compensation structure. During period of demand uncertainty such as decline stage, financial returns declines and business success and customer demand falters. During this stage, the growth rate may begin to decline and even become negative and earning power of the organization will also be declining.

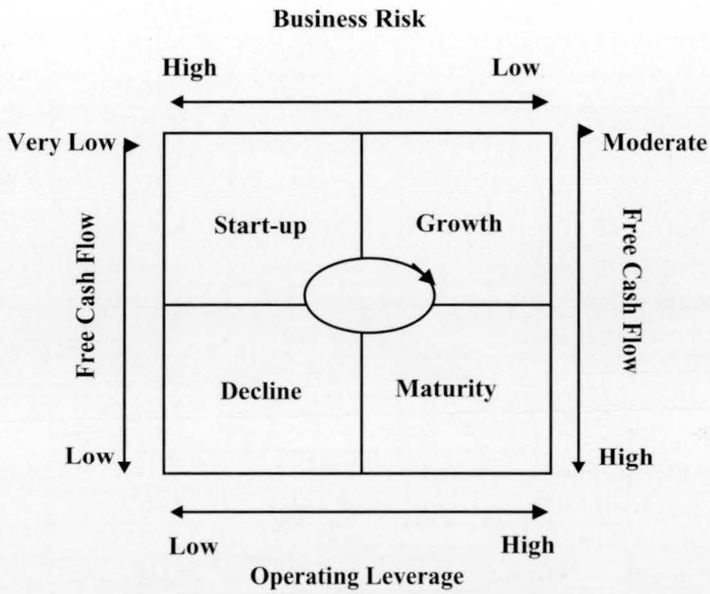
The business risk is becoming high and the central focus of the organization becomes survival rather than earnings. Figure 3 provides relationship of business risk, operating leverage and free cash flow. To minimize increased business risk during start-up and decline stages, organizations must reduce commitment to fixed pay and maximize the use of variable pay, which the organization incurs only if it achieves certain results. With low fixed cost, operating leverage will also be low. Low operating leverage means less variability of operating income during change in revenue. Hence, during start-up and decline stages of OLC, low operating leverage is preferred.

Growth and Maturity Stages

In growth stage of OLC, operating income is increasing, while business risk is moderating. Organizations in maturity stage of life cycle are more likely to be operating in more stable environments where product market becomes established and business risk reduces further. The maturity stage is often reflected by high free cash flows, due to less availability of attractive investment opportunities. During growth and maturity stages of OLC, organizations prefer a high degree of base pay; hence, typically they have high operating leverage.

Figure 3: Business Risk, Free Cash Flow and Operating Leverage during OLC

(Source: Matrix developed by author)



High operating leverage results in more operating income from each additional sale if they do not have to increase proportional costs to realize more sales.

Rebalancing Fixed and Variable Pay during OLC:

An Illustration

One of the learnings from anthropology study is that all organisms must evolve through time and adapt to their environment. Accordingly, organizations also must obey this physical law. If organizations adapt to changing circumstances, they are likely to be more successful (Duncan and Flamholtz, 1982).The organization must adjust its overall systems to fit with the changed external and internal environment. When an organization experiences a change in the environment, it will adjust its strategy and structure to fit with the new environment. Accordingly, compensation systems should in turn be adjusted to support the changed strategy and structure of the organization (Gerhart and Milkovich, 1992). Compensation is the most important reward used by organizations to motivate salespeople (Churchill, *et al.*, 1979). Table 2 shows a hypothetical illustration of a SME that rebalances fixed and variable pay of salespeople according to the different stages of OLC. Fluctuations in sales growth, profit margin, and free cash flow are normal outcome of different stages of OLC as shown in the illustration.

Table 2: Rebalancing Fixed and Variable Pay of a SME according to OLC

Sl. No.	Calculation	OLC Stages: Start-up	Growth	Maturity	Decline
(1)	Sales forecast (units)	65000	81900	84415	65000
(2)	Change in sales (units)		26%	3%	-23%
(3)	Unit Selling Price	$7.50	$7.65	$7.55	$7.40
(4)	Sales revenue= (1)*(3)	$487,500	$626,535	$637,334	$480,998

(5)	Threshold Sales (units)	42000	55000	54000	40000
(6)	Unit variable cost	$3.50	$3.50	$3.50	$3.50
(7)	Commission rate	12%	10%	10%	12%
(8)	Variable pay	$20,700	$20,579	$22,963	$22,200
(9)	Fixed pay	$14,000	$21,000	$18,000	$13,000
(10)	Total pay = (8) + (9)	$34,700	$41,579	$40,963	$35,200
(11)	Variable pay/unit = (8) / (1)	0.32	0.25	0.27	0.34
(12)	Total variable cost/unit = (6) + (11)	$3.82	$3.75	$3.77	$3.84
(13)	Unit contribution margin = (3) - (12)	$3.68	$3.90	$3.78	$3.56
(14)	Contribution margin =(1) * (13)	$239,300	$319,307	$318,918	$231,299
(15)	Fixed cost (including Advt. cost)	$88,500	$142,000	$135,000	$84,000
(16)	Total fixed cost = (9) + (15)	$102,500	$163,000	$153,000	$97,000
(17)	Total variable cost = (1) * (12)	$248,200	$307,229	$318,416	$249,699
(18)	Total cost = (16) + (17)	$350,700	$470,229	$471,416	$346,699
(19)	EBIT (Earnings before interest and taxes) = (4) - (18)	$136,800	$156,307	$165,918	$134,299
(20)	BEP (Break Even Point) (units) = (16) / (13)	27842	41808	40498	27259
(21)	Fixed pay / total pay = (9) / (10)	40%	51%	44%	37%
(22)	Variable pay / total pay = (8) / (10)	60%	49%	56%	63%
(23)	Fixed cost / sales revenue = (16) / (4)	21%	26%	24%	20%
(24)	Operating leverage =(14) / (19)	1.75	2.04	1.92	1.72
(25)	Capital Expenditure	$106,000	$110,000	$102,000	$97,000
(26)	Change in Working Capital	$33,000	$34,000	$33,500	$33,000
(27)	Free Cash Flow	($2,200)	$12,307	$30,418	$4,299
(28)	Interpretation of Free Cash Flow	Very Low	Moderatre	High	Low

(Source: Calculated by author)

As calculated in Table 2, Figure 4 through 7 shows break-even point (BEP) during different stages of OLC while Figure 8 shows operating leverage during OLC. There is evidence to show that the form of compensation change to fit the OLC stage (Balkin and Montemayor, 2000). For example, as organizations at early stages of their life cycle i.e. inception or start-up face strong cash demands to finance expansion of capital expenditure. Hence organizations in this stage of life cycle rely more on variable pay in lieu of higher base pay in compensation structure as a means of conserving cash for investment and growth.

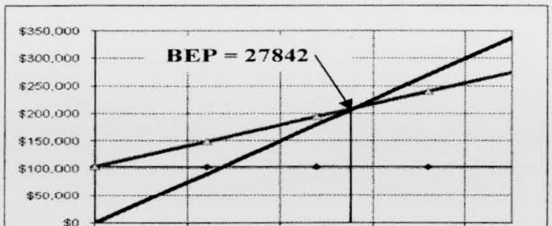


Figure 4: Start-up stage: BEP

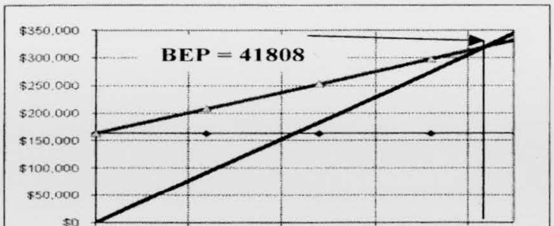


Figure 5: Growth stage: BEP

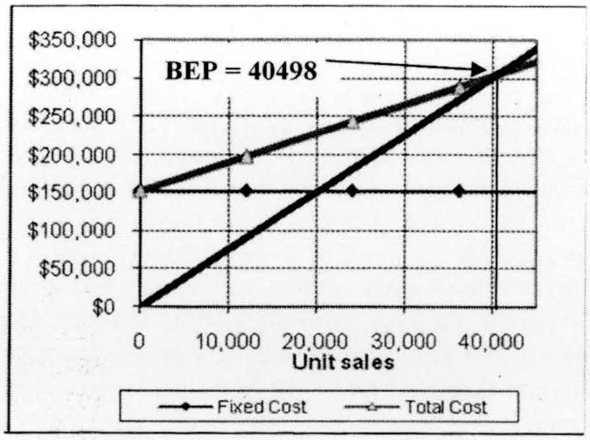


Figure 6: Maturity stage: BEP

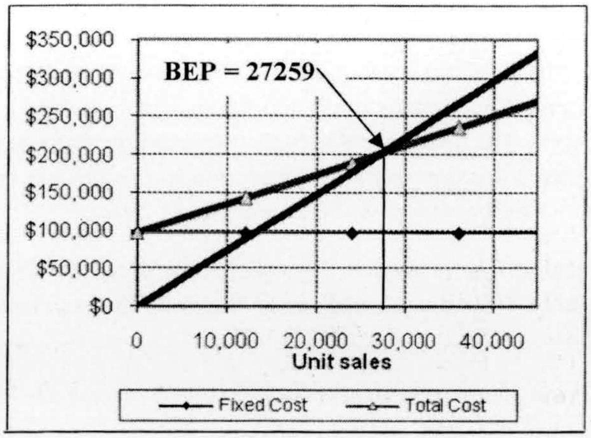


Figure 7: Decline stage: BEP

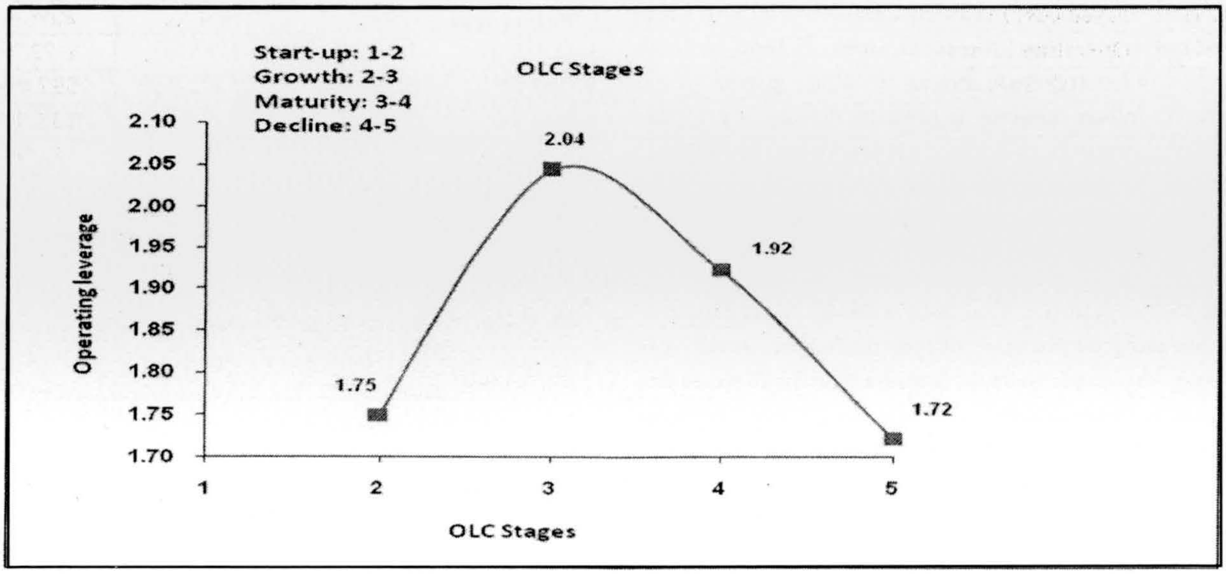


Figure 8: Operating leverage during different stages of OLC

(Source: Chart developed by author)

During growth and maturity stage, higher proportion of fixed pay in compensation structure and hence, high operating leverage will help organization in magnifying operating income sharply during period of higher revenue growth. During the decline stage of OLC, when product and market uncertainties are high, sales revenue and sales volume turn down; free cash flow and profitability also decline. During this stage, organizations focus on survival, and a reduction in sales force costs can contribute to it. Hence, lower base pay in compensation structure is advocated. Thus, organizational life cycle can provide some key insights to HR managers to foresee when organizations are most likely to change incentive plan. The OLC stages require decisive action from top management and results in the transition from one stage to the other. The manner in which the organization addresses these critical issues can play a key role in the success or failure of the organization (Mack and Quick, 2002).

Realigning Compensation Structure According to OLC: Scenario of Indian Small and Medium Enterprises (SMEs)

Small and Medium Enterprises (SMEs) play a crucial role in the growth of Indian economy. SMEs contribute 45 percent of industrial output and, 40 percent of exports in Indian economy. SMEs employ 60 million people, create 1.3 million jobs annually and produce more than 8000 products for the Indian and international markets. SME's contribution towards Gross Domestic Product (GDP) was 17 percent in Indian GDP for the year 2009 and is expected to increase to 22 percent by 2012. There are 26.1 million SMEs in India and by nurturing them; the rural areas of India will be developed in synergy with overall economy growth of the country. As Indian economy is growing rapidly, it provides ample opportunities to Indian entrepreneurs in various industries like manufacturing, precision engineering, food processing, pharmaceutical, textile and garments, retail, IT and ITES, agro and service sector, to launch SMEs in these lucrative sectors.

SMEs are the growth engine of Indian economy, hence it is necessary for, them to make optimum utilization of the resources, both human and economic, to achieve long term success and competitive advantages. Compensation strategy plays an important role in not only recruiting and retaining employees in SMEs but also increasing employee satisfaction, rewarding and encouraging best performers and reducing turnover and enhancing employee loyalty. Indian SMEs need to reduce overall cost of products to remain competitive with Chinese exporters and manufacturers. Apart from other functional areas such as production, finance, marketing and inventory and logistics, SMEs also need to focus on implementing best HR practices. As SMEs focus more on running the business on a day-to-day basis, they find less time to manage the HR which is perceived as non-priority. SMEs should monitor compensation cost to remain competitive in this era of globalization and stiff competition. By proactively adjusting compensation strategy according stages of OLC, HR manager can enhance competitiveness of SMEs.

Research Implication and Analysis

This article gives an explanation of OLC, its impact on firm performance, and response of HR manager for effective compensation management during different stages of OLC. Organizations must review and update sales people compensation strategy, according to OLC. Rebalancing fixed and variable pay in compensation structure according to different stages of OLC will help in designing optimal compensation strategy. During different stages OLC, sales revenue, business risk and free cash flow of SMEs change considerably. The OLC is an integral part of SMEs and therefore coping with it effectively is also a part of the HR strategy. It is necessary for HR manager to identify the stages of OLC for SMEs, and then proactively manage it for building competitive advantage.

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