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**DESIGNING NIMBLE REWARD SYSTEMS**

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Organization designs are changing in response to a changing world. In this paper we are especially concerned with a pattern of change that is beginning to have a critical impact on pay systems. That is the movement to much more flexible, nimble, and simple organizational forms. The pay systems used by most organizations are far too rigid, cumbersome, and complex to support the new organization designs. As a result, much contemporary thinking about compensation systems is outdated.

Managers increasingly understand the importance of speed in the design of new products and services, in production cycle times, and in getting products and services to market. Stalk and Hout, in Competing Against Time (1990), argue that time-based competitors learn more quickly what the customer wants, experience lower costs, are able to charge premium prices, and lead innovation in their industries. They present evidence that time-based competitors such as Wal-Mart and Citicorp are two or more times as profitable and grow several times as fast as their average competitors. New product development provides a clear example of the competitive advantage of speed. Internal studies by Hewlett-Packard indicate that a time delay of six months in project completion can result in a 32 percent loss in after-tax profit, while a 50 percent engineering cost overrun reduces profitability just four percent (Davidow and Malone, 1992).

In every segment of the economy, companies are attempting to gain a competitive advantage by increasing speed. Boeing is radically reinventing itself to cut its production cycle for its planes more than 50 percent while also cutting costs 25 to 30 percent (Tully, 1993). Boeing hopes to avoid the frequent order cancellations that result when the airlines place orders in boom times and cancel them during cyclical busts. VF Corporation, the maker of Lee and Wrangler jeans, has gained a far greater market share than Levi Strauss. This is largely the result of an information

system that allows VF to cut restocking time from three months to three days for major customers (Weber, 1995). The Chairman of retailer Dayton Hudson announced a series of changes in the firm by explaining, “Speed is life” (Chandler, 1995).

Many organizational changes that are becoming standard practice in the U.S. economy are a response to competitive pressures for speed and flexibility. Firms are using every tool at their disposal to become “lean and mean.”

- New technologies revolutionize the firm’s ability to meet customer needs. For example, flexible automation permits “mass customization” of manufactured products. Rapid technological innovation can overwhelm slow-footed competitors.
- Information technology permits companies to respond to changes in market demand almost instantly. Information technology also permits new forms of organizing. It permits a flattening of the hierarchy as technology replaces middle management. It also makes it easier for organizations to locate work anywhere in the world that work can be done well and cheaply, and to communicate among locations instantly.
- New organizational forms are lean and flexible. “Lateral organization” forms use cross-functional teams and work group teams to reduce or replace hierarchy as a faster way of coordinating work. “Network organization” forms are used by organizations to do only what they do best. Since everything else is a competitive distraction, the organization outsources as much as possible of the remaining work.
- Many quality practices, such as just-in-time inventory management and collaboration with suppliers, are intended to decrease activity cycles and increase speed.
- Reengineering is the attempt to rethink the way work is done to eliminate work that does not add value and that slows the organization’s response to changing business needs.

Clearly, the successful organizations of the mid-1990's look different and behave differently than their counterparts of a generation ago.

Conventional reward systems are a profoundly conservative force. They encourage employees to act within the narrow confines of their current jobs. However, older pay systems cannot keep pace with current business needs. Many experts believe that job evaluation, the basis of most job-based pay systems, is becoming obsolete because it cannot keep pace with changes in contemporary organizations (Bennett, 1993). Older pay systems do not reward employees for acquiring new skills in an era of technological change. Downsizing and delayering reduce opportunities for rewarding employees with promotions, forcing employees to rethink the nature of careers. Downsizing in the compensation function reduces the ability of staff specialists to control compensation policy and practice, forcing a greater reliance on line management for these tasks. Conventional reward systems fail to reward employees for the behaviors that are needed to make organizations competitive in a world that demands more nimble organizational forms.

Although compensation practice has lagged change in other areas of organization design, compensation practice is finally beginning to change in fundamental ways (Lawler, 1990; Schuster and Zingheim, 1992). Organizations need employees who can think broadly about the work to be done and business needs, and take responsibility for identifying and making needed changes even without management direction. This requires a shift in every facet of compensation practice. Even pay practices that are regarded as innovative, such as broad banding and skill-based pay, will need to be designed in ways that make them nimble and flexible rather than static and rigid.

The greatest shift will be in how managers think about compensation practice. Compensation has long been the most precise, complex, and quantitative area of human resource practice. The precision and complexity of the past, however, insures that pay systems are continually out of alignment with business needs in an era of change. Increasingly, we will need to

embrace pay systems that are somewhat sloppier, simpler, and more flexible. Pay systems will change frequently because the businesses they are supporting will change. They must be simple enough for line managers to understand, implement, communicate, and administer because there will not be enough compensation specialists left in most organizations to do the job. Pay systems will need to mirror the ever more fluid conditions found in modern organizations.

This article explores the meaning of nimble pay systems as it is reflected in a number of areas of compensation practice. These including the architecture of the pay system, pay for skills, performance management, and variable pay. We will also explore shifts in the pay design process.

### **Nimble Pay Architecture: Broad Banded Pay Structures**

The grade structure of a pay system provides an overall architecture that, intentionally or not, sends cultural messages. Most large organizations have dozens of pay grades. The use of many grades is consistent with bureaucratic emphasis on hierarchy, status, and the division of labor. Each hierarchical level typically has one or more pay grades, and the organization can hold out the promise of relatively frequent promotion to higher grades as a reward for good performance. The use of numerous grades also facilitates the control of salary inflation by limiting how far an employee's salary can increase without a formal promotion.

Broad banding reduces the number of grades in the organization. Companies such as General Electric and Northern Telecom recently have combined grades until only as few as six remain in the entire corporation or large business unit. As grades merge, the spread between the bottom and top of the pay range increases from perhaps 35 to 50 percent to as much as 200 or 300 percent. Firms using broad banding often eliminate the use of traditional pay management tools such as point factor job evaluation and range controls.

Broad banding is a relatively new concept, and there is virtually no research on the topic except for a survey study by Hewitt Associates (Abosch and Hand, 1994). As a result, little is

known about the advantages and problems that organizations experience in adopting this practice. At this point, some general conclusions seem appropriate.

Broad banding is a better fit than a complex grade structure for nimble organizations. A company that has radically delayered and that has promoted flexible, lateral, team-oriented structures for managing the business may find that a complex grade structure is dysfunctional. Why does the organization need thirty pay grades if it has only six hierarchical levels?

Broadening pay bands may increase employee flexibility by reducing instances in which employees are reluctant to take assignments that are not associated with opportunities for promotion to a higher pay grade. Some firms adopting broad banding expect that most employees will remain within one band, such as an engineering band or a middle management band, throughout their career. Rather than thinking in terms of a narrow job description and a corresponding narrow pay range, employees may come to think about contributing what they can to create greater opportunities for increased pay.

Broad bands have other advantages. Broad bands may have a positive impact on motivation because managers have more flexibility in rewarding sustained good performance with more pay, even without a promotion. Perhaps most important, companies adopting broad banding often hope to reduce the time, effort, and energy formerly expended on managing complex pay grade systems.

Broad banding may also create problems. Broad banding may be introduced so tentatively that it becomes a nonevent for employees. The Hewitt Associates study found that many organizations that claim to be using broad banding are actually using “fat grades.” This means reducing the number of grades but not radically combining them, for example reducing 30 grades into 25 bands. Other organizations do “career banding,” which we have described here, but limit the plan by including “zones,” “shadow ranges,” “market reference points,” or other substructures

to the bands. Employees may be forgiven if they find little difference between two pay systems, one with 21 grades, the other with seven grades each containing three “zones.”

Managers are likely to be concerned about control of compensation costs and internal pay equity if neither artificial limits such as zones nor traditional compensation tools such as midpoints are used. At the very least, line managers must assume far greater responsibility for communicating with employees about their place and opportunities in the bands. Managers cannot easily blame the compensation function for pay decisions that employees dislike; line managers must take responsibility for their decisions in a broad banded system. Otherwise, employees may assume that their pay will increase far more and far faster than in conventional systems, leading eventually to great frustration and disappointment.

Finally, broad banding is not compatible with all organizational cultures. Organizations that are highly bureaucratic may be comfortable with the greater degree of control, emphasis on hierarchy, and differentiation of employees that traditional grade systems provide. For these reasons, Philip Morris considered and rejected broad banding (Abosch, Gilbert, & Dempsey, 1994). Nimble reward systems are appropriate only for nimble organizational designs.

### **Nimble Pay for Skills System**

Skill-based pay (SBP) plans take several different forms (see the article in this issue on “New Directions in Paying for Skills, Knowledge, and Competencies”). For most compensation professionals, the term skill-based pay evokes the classic skill-based pay system of the type Procter & Gamble first installed in the mid-1960s. These plans reinforced high involvement organization designs that made use of self-directed work teams, an unusually high level of training, extensive communication of business information, and well as other innovations. The classic SBP plans emphasized skill breadth, which enhanced employee flexibility and problem solving capabilities, and the social skills needed to operate in a team-based organization.

Although these first-generation skill-based pay plans offered a number of advantages, they were far from nimble. The entire design and installation process usually took a year or two for an organizational unit of a few hundred employees. The plans were comprehensive, typically covering all the skills used in the jobs of virtually all non-exempt employees. (However, exempt employees usually were excluded from the plan.) Skills were grouped into compensable skill blocks. Training requirements and certification standards were developed for each skill block. The organization expected to achieve a return on its investment in such a complex design process by using the pay plan, with relatively minor modifications, for the next ten or twenty years.

Nimble forms of skill-based pay challenge each of the assumptions underpinning the design of the classic skill-based pay plans. Nimble skill-based pay plans may pay for skills with bonuses rather than base pay increases. Such plans also may cover only a limited set of employee skills, or may cover only a part of the employee population.

A skill-based pay system that uses bonuses is better than a system based on permanent salary increases when employee skills are changing rapidly. It may not make sense to increase salaries permanently in exchange for knowledge that has only a temporary value. In many scientific, engineering, and technical disciplines, new knowledge becomes obsolete in as little as five years. The usual one- to two-year skill-based pay design process is not helpful in this situation because the plan may be largely obsolete before it is implemented. To take a familiar example, nothing that a technician or engineer might have learned about personal computer technology just ten years ago is worth paying for today. The hardware, peripherals, operating systems, and software are completely different, and PC networks and the Internet are now everyday work tools rather than mysterious concepts. Why should anyone be receiving annuity-like pay increases in 1995 because of the personal computer skills they learned in 1985? A bonus-oriented system can offer employees incentives to continually obtain needed skills and knowledge.

Bonus systems are desirable because they permit sloppy and even unstable plans. The organization does not need years to design a very careful plan, because the cost of error is not as great in a bonus-oriented system. If it turns out that some skills were not needed after all, the only cost to the organization is one year's bonuses for those skills. By contrast, the organization using a first-generation skill-based pay plans must be careful about granting annuity increases in base pay. Also, a bonus-oriented system is much more flexible than a base-oriented system. If necessary, the skills for which bonuses are paid can be changed every year to keep abreast of changing business needs.

Skill-based pay plans--especially those using bonuses--need not be comprehensive pay systems. The organization may gain a competitive advantage from a skill-based pay plan that covers some but not all employees, or some but not all skills. Most organizations have avoided this approach so that managers will not have to tell some employees that they are ineligible for skill-based pay opportunities. However, pay equity is not necessarily the same as pay equality. It is better to suffer some minor grumbling than to install a pay system that pays some employees for unneeded skills, or that fails to reward the acquisition of needed skills by part of the work force.

Loosening our assumptions about the forms that skill-based pay can take will permit new forms of skill-based pay to emerge. These new forms of skill-based pay are applicable to populations that have been excluded from skill-based pay in the past, such as managers, engineers, information technology professionals, and other knowledge workers. We are just beginning to see such plans. For example, a consumer products company has installed a plan that rewards all managers for their progress on four key competencies that are relevant to all managers in the company. An aerospace business unit of another company pays engineers and other professionals for meeting "learning contracts" that are negotiated between supervisors and subordinates.

### **Nimble Pay for Performance: Performance Management**

Conventional performance management is cumbersome and often ineffective. It is one of the supervisor's most time-consuming and least favorite responsibilities. It also is becoming difficult to do well in organizations with ever-increasing spans of control.

Nimble performance management makes use of 360 degree appraisals, which provide performance feedback from supervisors, subordinates, peers, and customers. Such appraisals often are a necessity in delayed organizations, where the supervisor may have dozens of subordinates. In these conditions, the supervisor alone cannot know how every subordinate is performing, and must rely on others to give detailed feedback to subordinates.

An important step is simplifying the performance rating process. The ratings required by conventional performance appraisal forms can be extremely complex. One Fortune 500 firm rates all employees on a 150-point rating scale. It is not uncommon for firms to require ratings of all employees on 10 to 20 attributes, with prose commentary on each. The numbers produced by most such rating processes represent pseudo-precision rather than valid or reliable measurement. As a result, many companies are attempting to reduce ratings complexity in order to increase the validity and utility of the performance management process. For example, some firms use very simple rating scales only to identify and appropriately reward exceptionally high or exceptionally low performers. They make no attempt to make fine distinctions in the performance ratings or rewards of the majority of employees, who are doing their job well. Other firms, such as AMOCO, use an appraisal process that delivers feedback but no summary rating at all. The feedback focuses on behaviors, accomplishments, and objectives, not a rating number.

Simplified rating processes are an important supplement to 360 degree appraisals. Some research indicates that peers are very willing to provide valid feedback to that is not tied to financial rewards. They are less enthusiastic about providing peer feedback that affects pay, and may provide different ratings when feedback is used for performance appraisal as opposed to

development only. However, problems with peer feedback probably can be greatly reduced by simplified ratings. Employees usually show usually considerable agreement about which peers are performance outliers--that is, exceptionally high or low performers--and do not seem to be reluctant to identify these. The problem comes in making fine distinctions that employees do not feel able to make appropriately, such as between a “5” and a “6” rating on a seven-point rating scale. Eliminating the fine distinctions eliminates most of the problem.

Automation of the appraisal process is an important step. Over twenty vendors sell software that enables employees to deliver feedback almost instantly, as well as anonymously if appropriate, over computer networks or telephone systems. The organization may have an “appraisal day” in which 360 degree feedback for everyone in the organization is collected, collated, and delivered. This process moves at light speed compared with the ponderous paper process used by most organizations.

Another aspect of nimble performance management is an emphasis on bonuses rather than base pay increases for good performance. One of the many flaws of “merit pay” programs is that firms are unable to handsomely reward top performers who are high in their salary range. The annuity feature of merit pay demands compromises. Thus, mediocre performers who are low in their range often receive higher percentage increases than top performers with high salaries. An alternative recognizes that individual performance is variable from year to year, and as a result individual pay for performance should be variable as well. The organization thus separates base pay from pay for performance. Base pay increases should reflect market movement and increases in enduring value, such as by obtaining skills and competencies with greater market value. Pay for exceptional performance can be more handsome and more timely if the employee receives a bonus, rather than a small merit pay annuity.

There is still another reason for de-emphasizing individual pay for performance. Increasingly, organizations are adopting technologies and work systems that create a high level of interdependence among employees. In these conditions, emphasizing pay for individual performance can decrease the performance of teams and organizational units by encouraging employees to act as individual “stars,” not good team members. We next consider pay for organizational performance, which is appropriate for units in which employees are interdependent.

### **Nimble Pay for Performance: Variable Pay and Gainsharing**

Variable pay offers several potential advantages to the organization. If it rewards employees for increases in performance over which employees have some control, it has the potential to motivate greater collective performance. It also permits the organization to vary labor costs as organizational performance changes; labor costs rise when performance is high and fall when performance is low.

Most research and writing on organizational performance incentives has focused one type of variable pay plan, namely the Scanlon plan and similar gainsharing plans. The formulas used by such plans have two key features that are intended to motivate employees. First, the plans are based on productivity and similar performance metrics that, proponents believe, employees can affect directly. The second feature of Scanlon plans and similar variable pay plans is that the threshold for bonus payouts is historical. If performance exceeds the recent historical average (say, the average of the last three years), employees earn a bonus. A historical standard usually is accepted by employees as objective and achievable.

Scanlon plan experts hold that plans based on profit and financial return measures lack motivational value because employees have limited control over profitability and return rates. Profit is strongly affected by factors that are beyond employee control, such as market demand, sales price and volume, capital investment patterns, and accounting practices. Scanlon proponents

also look with disfavor on plans that pay out based on beating performance targets rather than beating historical averages. They argue that employees tend to view performance targets as arbitrary management “gimmicks,” and thus the targets may not motivate employees.

The only problem is that organizations do not seem to listen to the gainsharing experts. A study of over 650 variable pay plans (McAdams and Hawk, 1994) found that the formulas in almost half are based either entirely or partly on profit or other financial return measures. Also, only about about half of the plans paid out based on historical performance.

Why do so many managers ignore the conventional wisdom? A key reason is that the conventional gainsharing model applies to fewer and fewer organizations. The model is most relevant to organizations that face stable market conditions, do not experience abrupt changes in capital spending, and do not change performance goals frequently. Plans based on profit or financial return metrics and management-set targets can be used in a number of fluid situations that demand more nimble incentive systems. These include the following:

- New organizations, such as new plants or new companies, do not have the performance history to use a historical baseline and therefore must use targets. These organizations also may have a much clear idea of the rate of return they must earn to succeed than the rate of productivity they must experience, meaning that financial performance targets may be more realistic than unit performance targets.
- Organizations making major capital investment or technology upgrades may change the economics of the business to such a degree that historical baselines are irrelevant.
- Organizations experiencing rapid fluctuations in market demand and product mix also can experience very erratic productivity and other unit performance results that are no easier to communicate to employees than profit results.

- Increasing competition may mean to merely beating historical averages is a recipe for failure. A sudden increase in quality, productivity, and other key performance measures may be necessary for survival. In these conditions, a simple historical baseline may be inadequate.

There are other advantages to departing from conventional gainsharing designs. One of the most difficult bridges for managers to cross in accepting Scanlon-type plans is that the plan may pay out when the business is losing money. This is because profit is determined largely by market conditions, and the organization may be very productive and quality may be high even if market conditions are poor. This is not a problem if the plan is based on profit or financial return. Alternatively, the plan may combine different metrics. For example, it may pay out based on productivity and quality, but only if the organization is making a profit.

Problems with profit-based variable pay plans should not be underestimated. The line of sight between employee behaviors and these metrics is inevitably more difficult to establish. Management must do a more extensive job of communication with profit-based plans to help employees understand these plans and how they can influence the level of payout.

Target-based plans also face problems. The most severe is that the targets may not be credible with employees. The frame of reference of non-exempt employees is different from that of managers. Managers see variable pay performance targets that grow progressively more difficult each year as normal and similar to the way that organizations budget and set individual performance objectives. Employees may see progressively harder targets as similar to the manipulative use of piece rate incentives, and thus feel distrustful. Also, if employees do not see the targets as reasonable, the plan may not be motivating. They may feel lucky if the plan pays out, or feel that management purposefully set the targets too high if the plan does not pay out. Thus,

target-based plans require extensive communication between management and employees and a reasonably high level of trust if they are to succeed.

Variable pay plans that use financial measures and that use performance targets rather than historical performance as the threshold for pay outs thus have problems. Increasingly, however, organizations are deciding to deal with these problems because conventional gainsharing designs are too static, too limited, and too difficult to management in the turbulent conditions facing the organizations. In many situations, they determine that the benefits of more nimble designs outweigh the costs.

### **Nimble Pay Design Processes**

Managers tend to be painfully cautious in designing pay system changes. Firms tend not to use an array of different pay innovations, the way they use multiple employee empowerment practices, training practices, communication practices, and quality practices. Rather, they tend to try out one or two innovations at most (Lawler, Mohrman, and Ledford, 1992). Firms also tend to use pay innovations with fewer employees than are covered by other types of innovations. The typical pattern is carefully design and install skill-based pay, variable pay, or another pay innovation in an isolated corner of the company. Managers study the innovation over a period of several years, and then may carefully spread it to one or two more locations every few years.

Although the pilot approach has some advantages, a slow approach may be unsuccessful, even if it is based on pilot experiments that are extremely successful. Changes in business conditions mean that any specific pay experiment will be of limited relevance elsewhere before the diffusion process takes hold. Changes in management personnel eliminate the political support needed to overcome the inertia of old practices. The slow and careful approach often mobilizes opposition to the innovation because it remains different and threatening to the bulk of the organization that is using older, more familiar practices.

Nimble design processes are faster and deeper than more typical compensation design processes. They rely on aggressive time frames for design and implementation. In a plant, six to nine months is adequate for a thorough design and installation of a skill-based pay plan or a variable pay plan and all supporting systems (training, communication, evaluation, etc.). At the division or corporate level, multi-site installation of such innovations can be accomplished in one to two years. Indeed, multi-site installation of pay innovations is necessary if the innovations are to have an impact on division or corporate performance, rather than on team or plant performance. This requires the involvement and interest of higher-level line managers and compensation professionals than has been typical in the past.

Increasingly, large companies that see early success with compensation innovations are adopting those innovations on a mass scale. For example, Procter & Gamble has adopted skill-based pay in dozens of locations; Monsanto has installed variable pay plans in over half of its plants; and General Mills has adopted gainsharing and other variable pay plans in virtually every location in the company. Installation on this scale usually cannot be accomplished by the adoption of a standardized plan that fits all local conditions. Rather, the corporate role is to develop ground rules or parameters that allow locations to develop local plans efficiently, by signalling which design decisions must be consistent across locations and which are a local option. Corporate staff and line groups may also specify the design process that must be followed in order to develop an effective, approvable plan. Business units in companies such as AlliedSignal and Avery Dennison are developing “tool kits” that walk locations through the process of analyzing local business decisions and arriving at appropriate pay designs. Finally, corporate groups may provide internal resources or specify approved external consultants and other resources that locations may use to help develop local plans.

Organizations that use nimble design processes must of necessity use a self-design approach (Mohrman and Cummings, 1989). This means that the organization learns “on the fly” from ongoing experience in order to act effectively. Pay systems need to be custom tailored to the organization’s business strategy, structure, and culture. Because each of these is constantly evolving, no pay system can remain static and continue to be effective. Over time, any pay system will fall out of alignment with other elements of the organization design. To learn whether the pay system is working as intended and is meeting organizational needs, managers must periodically assess it. Doing this requires the organization to develop a clear pay philosophy, a set of goals for the innovative pay practices, and a model of how the plan should work before implementation. Both performance measures and measures of employee attitudes are helpful in gaining a full picture of the effectiveness of the pay plan.

### **Conclusion: The Future of Nimble Pay**

Changing business conditions will force more organizations to adopt simpler, more flexible, and more nimble pay systems in the future. Our discussion makes clear no simple list of practices characterize nimble pay systems. Both nimble and cumbersome pay systems may use broad banding, skill-based pay, performance management, and variable pay. The difference is in the forms these practices take and the processes used to install them.

The shift to nimble pay systems has many implications that organizations have only begun to explore. Employees are almost certainly to become more concerned about the potential for arbitrary management action, risk, and pay equity in nimble pay systems. Because the level of trust between employees and management is low today, this presents real challenges in developing and maintaining nimble pay systems. One answer will be an increase in the degree to which employee involvement is used to help develop pay systems that employees can understand and accept.

However, employee involvement in the pay arena will be a novel and difficult experience for companies that are used to making pay decisions unilaterally.

Moreover, it seems inevitable that line managers will play a larger role in compensation design and administration as staff groups shrink. Compensation expertise does not seem to come naturally to most line managers. How can they be trained to perform this role effectively?

Perhaps the most important implication of nimble pay systems is that they heighten the need for organizational learning. These are not standard practices used by most other companies, but customized practices that meet dynamic business requirements. Learning is necessary to discover what the organization needs, to understand what works and does not work given current conditions, and to detect when changes are needed to correct design errors or to regain alignment with business needs. This type of compensation design requires a fundamental shift in perspective and skills for many organizations.

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