

Special Report:

Piece Work and Alternative Compensation Systems

Piece work is a compensation system in which employees are paid for what they produce. For example, an employee is paid \$8 to assemble a widget. If it takes him an hour, he makes \$5 per hour. If it takes him 20 minutes, he makes \$15 per hour.

There are numerous ways to structure piece work. But they all essentially involve the principle of paying the employee by the piece— by some unit of production rather than by the hour.

Benefits of Piece Work

The primary benefit of piece work is that labor costs are directly related to production. If for example, you are paying \$5 for a worker to assemble a widget, your production cost is capped at \$5 per widget. Let us contrast this with a traditional hourly pay system.

We will assume that it takes a typical worker 20 minutes to assemble a widget and the typical pay rate is \$15 per hour. This works out to \$5 of labor costs per widget (the worker can assemble 3 per hour.) Under typical conditions, piece work and a traditional pay system cost the same.

However, let us say that the worker slows his pace only slightly. Instead of doing 3 widgets per hour, or 24 in an 8-hour day, let us say he only assembles 23. The labor cost per widget is now \$5.22 each or an increase of 4.4%. Small decreases in productivity can have a significant negative impact on the company. Further, the worker has no real incentive to be more productive or efficient—his pay rate is guaranteed.

Under a piece work system, the worker is paid for what he produces. If he only assembles 20 widgets in a day, he is paid for assembling 20 widgets. If he assembles 30 widgets, he gets paid for 30 widgets. In other words, his pay

is directly related to how efficiently he performs. If he performs above average, he is paid above average.

Most piece work systems also include quality standards. A piece must meet specific standards and criteria to be counted. Until the work meets the company's standards, it is not considered complete. For example, if the worker assembles 30 widgets in a day, but only 28 meet quality standards, he is paid for 28. This helps to eliminate cutting corners and poor craftsmanship.

(In some jurisdictions piece work is more difficult to implement because of state and local laws. Consult local authorities before implementing a piece work system.)

Piece work is regarded as the oldest form of pay for performance, and can be applied to virtually any industry in one form or another. Let us look at how piece work can be used in several different situations.

Manufacturing

Piece work can usually be successfully implemented in a manufacturing setting. The worker is simply paid for each unit produced, as in our widget example.

Some manufacturing situations may be more complex, such as the assembly of an automobile. In this case, a single individual does not assemble the entire automobile. In situations where multiple individuals are involved in a process, piece work can still be applied. As one example, individuals can be paid for each piece that they actually complete, such as \$X to attach the tires.

Service Companies

Service companies often use a form of piece work, paying the worker a fixed amount to complete a repair or other task. For example, a plumber might be paid \$X to replace a toilet; an electrician might be paid \$X to hang a ceiling fan; a telemarketer might be paid \$X per appointment set.

Salesmen

Salesmen have long been paid on a commission basis. While not a form of piece work, this is a performance based pay system.

In each of these situations the employer places caps on his labor costs, while providing incentives to his employees to perform efficiently and effectively. The result can be a win-win for both parties.

Creating a Win-Win

Piece work can create a win-win situation for the employee and the owner. The employee can make more money, and the owner can remove a significant source of financial stress— labor costs that go over budget.

But a piece work system can work only if the “piece” is priced fairly. To use our example with the widget, an owner cannot decide to pay \$4 per widget as an arbitrary means to spur production. He must give the employee a reasonable amount of time to do the job, or the employee will become discouraged and the system will collapse.

Setting Quality Standards

Establishing acceptable standards is a crucial part of a piece work system. Without standards it can become tempting to cut corners or otherwise reduce quality in an effort to increase quantity.

The standards should be provided in writing. Employees should be instructed in what will be acceptable, and what will not be acceptable. The standards should be reasonable and easily understood.

In some jurisdiction employees cannot be penalized for work that is below standard. Consult with state and local officials to determine the rules for your area.

Independent Contractors

In many industries it is common to use independent contractors, either on a temporary basis or on a full-time basis. Such contractors are typically paid a fixed amount to complete a job or task, and this can be an effective form of piece work. However, specific guidelines must be followed.

IRS Guidelines

Many small business owners believe that if they call someone an independent contractor and issue him a 1099 at the end of the year, he is indeed an independent contractor . Not only is this mistaken, it could be financially devastating. If the IRS determines that an individual is an employee, rather than an independent contractor , you will be liable for past taxes, penalties, and fines.

The following is taken from the IRS web site:

To determine whether a worker is an independent contractor or an employee under common law, you must examine the relationship between the worker and the business. All evidence of control and independence in this relationship should be considered. The facts that provide this evidence fall into three categories – Behavioral Control, Financial Control, and the Type of Relationship itself.

Behavioral Control covers facts that show whether the business has a right to direct or control how the work is done through instructions, training, or other means.

Financial Control covers facts that show whether the business has a right to direct or control the financial and business aspects of the worker's job. This includes:

- The extent to which the worker has unreimbursed business expenses,
- The extent of the worker's investment in the facilities used in performing services,
- The extent to which the worker makes his or her services avail-

able to the relevant market,

- How the business pays the worker, and
- The extent to which the worker can realize a profit or incur a loss.

Type of Relationship covers facts that show how the parties perceive their relationship. This includes:

- Written contracts describing the relationship the parties intended to create,
- The extent to which the worker is available to perform services for other, similar businesses,
- Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay,
- The permanency of the relationship, and the extent to which services performed by the worker are a key aspect of the regular business of the company.

To address these issues, the IRS uses 20 questions to determine if an individual is a subcontractor or an employee. Those questions are:

- Is the worker required to comply with instructions?
- Is the worker provided with training?
- Are the worker's services integral to the business operations?
- Must the worker render the services personally?
- Who has the power to hire, supervise and pay assistants?
- Is there a continuing relationship?
- Are there set hours of work?
- Is there a full-time work requirement?
- Is the work done on the premises of the business?
- Is the order or sequence of the work established?

- Are oral or written reports required?
- Is payment made by the hour, week or month?
- Who pays the worker's business and/or travel expenses?
- Who furnished the worker's tools and materials?
- Has the worker made a significant investment for work facilities?
- Will the worker realize a profit or loss from the activity?
- Does the worker work for more than one business at a time?
- Are the worker's services available to the general public?
- May the worker be discharged?
- Does the worker have the right to terminate the relationship at any time?

While a “wrong” response to one or more of these questions will not necessarily lead to a determination that an individual is an employee, the more “correct” responses the better. In other words, a true independent contractor will result in a preponderance of “correct” answers.

In general, the greater the control over the individual's work, the greater the likelihood that he will be classified as an employee. If you dictate how the work is to be performed, the worker will probably be classified as an employee.

Financially, the worker must have the possibility of making a profit or sustaining a loss. If you pay him by the hour, day, week, etc. he is an employee—there is no financial risk. If you provide benefits, such as vacation or holiday pay, he is an employee. Further, if you supply the worker with tools and equipment he is probably an employee. If he has made the investment in his own tools and equipment, he is more likely to be classified as an independent contractor .

If the individual can only provide his services to your company he is likely an employee. If he can provide his services to other businesses, or the general public, he is more likely an independent contractor .

As the above should make clear, properly classifying your workers is of critical importance. You should consult with competent professionals before classifying anyone as an independent contractor.

Conclusion

Piece work can be an effective alternative to traditional payment systems. It can provide financial relief to the business owner, while creating an opportunity for employees to make more money.

If you would like to learn more about developing systems and procedures for your business, visit <http://smallbizsystemz.com>