CHAPTER - 1

Introduction to Compensation Management

- ***Meaning of Compensation.***
- ***Role of compensation in organisation.***
- ***Economic & behavioural issues on compensation.***
- ***Compensation as a motivational tool.***
- ***Frame work of compensation policies.***
- ***Process of designing compensation system.***
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Introduction to Compensation Management

Meaning of Compensation

Compensation is a systematic approach to providing monetary value to employees in exchange for work performed. Employee compensation may achieve several purposes in recruitment, job-performance and job satisfaction.

"Employee compensation refers to all forms of pay going to employees and arising from their employment[1]".

Compensation can be defined as all the rewards earned by employees in return for their labour. Compensation in typically divided into direct & indirect components.

- **Direct Financial Compensation** consisting of pay received in the form of wages, salaries, bonuses and commissions provided as regular and consistent intervals.
- **Indirect Financial Compensation** including all financial rewards that are not included in direct compensation and can be understood to form part of the social contract between the employer and employee such as benefits, leaves, retirement plans, education, and employee services.

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1. Gary Dessler, (2012) : Human Resources Management, Student Value Edition (13th edition) January 10, 2012, pg. 350.

- **Non-Financial compensation** referring to topics such as career development and advancement opportunities, opportunities for recognition, as well as work environment and conditions.

In determining effective rewards, however, the uniqueness of each employee must also be considered. People have different needs or reasons for working. The most appropriate compensation will meet these individual needs. To a large degree, adequate or fair compensation is in the mind of the employee.

A good compensation strategy includes a balance between internal equity and external competitiveness. Compensation and benefits affect the productivity and happiness of employees, as well as the ability of your organization to effectively realize its objectives. It is your advantage to ensure that your employees are creatively compensated and knowledgeable of their benefits.

Chart – 1.1

Types of Compensation

Financial		**Non-Financial**	
Direct	**Indirect**	**The Job Position**	**Work Environment**
Equitable wages and salaries Market adjustments or cot of living increases Merit increases or	Insurance Plans, Life, Supplementary Health, Dental, Vision, Disability, Coverage. Social security	Interesting Duties and Responsibilities, Challenges, Authority, Autonomy, Opportunity for	Fair and Consistent, Practices and policies, Competent Supervision Fun and Effective

performance Bonuses Fair Commissions	benefits, Retirement plans, Employment/ Insurance, Workers Compensation, Educations Services, Employees Services. Paid Absences, Vacations, Holidays, Sick Leave, Educational Loan, Join duty, Compassions are leave.	recognition feeling of achievement, advancement opportunity.	Co-workers. Comfortable and Safe Working Environment, Flexible Scheduling, Alternative Working Arrangements. Modified Retirement.

Role of Compensation in Organisation:

- An ideal compensation system will have positive impact on the efficiency and results produced by employees. It will encourage the employees to perform better and achieve the standards fixed.

- It will enhance the process of job evaluation. It will also help in setting up an ideal job evaluation and the set standards would be more realistic and achievable.

- Such a system should be well defined and uniform. It will apply to all the levels of the organization as a general system.

- The system should be simple and flexible so that every employee would be able to compute his own compensation receivable.

- It should be easy to implement, should not result in exploitation of workers.

- It will raise the morale, efficiency and cooperation among the workers. It being just and fair would provide satisfaction to the workers.

- Such system should also solve disputes between the employee union and management.

- The system should follow the management principle of equal pay.

- It should motivate and encourage those who perform better and should provide opportunities for those who wish to excel.

- Sound Compensation/ Reward System brings peace in the employees and relationship of employer and employees.

- It aims at creating a healthy competition among them and encourages employees to work hard and efficiently.

- To establish a positive corporate reputation to achieve entire sectioned equity[2].

- The perfect compensation system provide s platform for happy and satisfied workforce. This minimizes the labour turnover. The organization enjoys the stability.

- The organization is able to retain the best talent by providing them adequate compensation there by stopping them from switching over to another job.

- The business organization can think of expansion and growth if it has the support of skilful, talented and happy workforce.

- The sound compensation system is hallmark of organizations success and prosperity. The success and stability of organization is measured with pay -package it provides to its employees.

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2. G.C. Mohanta (2013) "Role of compensation organisation Business, Economy & Finance.

Economic and Behavioural issues in compensation

Many behavioural scientists- notebly industrial psychologists and Sociologist have presented their views on the research studies and programmes conducted by them. Briefly such theories are :

The Employee's Acceptance of a compensation level:

This type of thinking takes into consideration the factors which may induce an employee to stay on with a company. The size and prestige of the company, the power of the union, the wages and benefits that the employee receives in proportion to the contribution made by him- all have their impact.

The Internal Compensation Structure:

Social norms, traditions, customs prevalent in the organization and psychological pressures on the management, the prestige attached to certain jobs in terms of social status, the need to maintain internal consistency in compensation at higher level, the ratio of the maximum and minimum wage differentials, the norms of span of control, and Demand for specialized labour all affect the internal wage structure of an organization[3].

3. R.S. Meena (2010), "Salary & wages administration, International Journal of Department Studies.

Wage and Salary and Motivators:

Money often is looked upon as means of fulfilling the most basic needs of man. Food, clothing, shelter, transportation, insurance, pension plans, education and other physical maintenance and security factors are made available through the purchasing power provided by monetary income- wages and salaries. Merit increases, bonuses based on performance, and other forms of monetary recognition for achievements are genuine motivators. However, basic pay, cost of living Increases, and other wage increases unrelated to an individual's own productivity typically may fall into maintenance category.

Economic and Behavioural Issue in Compensation Management:

The nature of Human Resource market is one of the most important issues affecting compensation plan of any organization. In analyzing the nature of human resource market there are three issues which must be Analyzed. These are–

- Demand and Supply
- Productivity
- Prevailing market rate of wages and salary of different classes of personnel

1. Demand and Supply:

The nature of demand and supply are of various types and operates at regional, national and global level and determine wages and salary structure. In the case of Human Resource the level of demand and supply of a productise decided-If the demand of a certain category of product exceeds their supply their price is tend to be higher in respect of their productivity-which may reduce productivity of human resource in another market or remain constant. The employer's demand for labour is dependent on a number of factors such as demand for his/her product, availability of other factor of determination, the level of technological progress, etc.

2. Productivity:

Productivity of human resource is another market related force which affects compensation management. If productivity of a personnel is high the wages and salary rate will also he high and if the productivity of personnel is low the wage s and salary payable to him will also be low. E.g. many foreigners have opted to open their Business in India though there are many issues behind it. One of those factors/issues is low employee cost but this low employee cost is offset by lower productivity in

India. There is low productivity in India as compared to other industrial advanced countries.

Prevailing market rate of wages and salary of different classes of personnel this is also known as comparable rates. Prevailing market Rate helps an organization in deciding compensation plan in several ways like in order to attract and retain the personnel with certain specific skill, it is essential to pay comparable rates. If an organization wants to acquire personnel with the similar skills as his competitor's have therefore they have to pay competitive rates. In determining the rate of prevailing market in formulating compensation plan an organization can act as a leader or it may act as a follower.

Cost of Living:

While nature of resource market affects different classes of personnel. Different cost of living affects all personal at one place. Similarly cost of living varies at different levels i.e. from country to country and different place within a same country e.g. urban and rural areas varies from a place over a period of time because of Inflating rate of money. So cost of living may also be taken as the base for adjusting compensation plan e.g. wages and salary in industrial advanced countries are much higher than the economically less developed countries.

So from the above description we can conclude that economic and behavioural issues have their own importance and have great impact on compensation management so such issues like demand and supply, productivity prevailing market rate and cost of living should be given considerable importance while doing compensation management.

Compensation as a Motivational Tool:

Compensation can be said to be the reward or remuneration for a task performed. Compensation plays a key role in job performance. The effect of compensation can be negative if monetary compensation and finding benefits inadequately satisfy the worker. Apart from monetary compensation strong motivators include recognition and promotion which boosts the workers morale. Apart from basic salaries and wages other monetary compensations employed for employers include commissions and bonuses.

Compensation cannot directly improve employee performance, but is able to increase motivation and strengthen organizational commitment. Motivation gives a strong effect on relationship between compensation and employee performance[4].

4. Muhamad Rizal, M. Syafiie Idrus, Djumahir, Rahayu Mintarti (2014). "Effect of compensation on motivation, organizational commitment and employee performance (studies at local revenue management at Kendari City, International Journal of Business and management Invention, Volume 3, Issue 2, February 14, PP. 64-79.

A rigid compensation structure could limit the efficiency because employees expect a fixed comp. irrespective of job input. Company vacation, health insurance, housing allowance, transportation and meals/snacks end also year and bonuses can be strong sources of motivation. Employer help to achieve, the company's goals by performing assigned jobs, Employee seek motivation to meet the design lied goals in which the country is able to help them by setting attainable conditions and measures[5].

A well thought and fair compensation system aligned with success in fulfilling the designated goals is the basis of "Social Peace" in the company and surely motivates employers to deliver the required performance. However attention should also be paid to nonfinancial motivational tools. The harder it is to define and grasp these tools the more significant a role they play in motivating employees.

Frame Work of Compensation Policies:

Compensation policies at the company level are subject to the overall legislative and other mandatory principles established by the Government. A variety of considerations both objective and subjective weight the determination of compensation policies at the company level.

5. Bruno S. Frey, Margit Ostzerloh (2002) "Successful management by motivation : balancing intrinsic and extrinoic incentives, springer-verlag Berlin, Heidelberg, New York, 2002, Pg. 53-54 .

There is a need for a balance between organisation design and company policies. Companies also need to consider the policies of other companies. The pressure of collective bargaining and the profile and expectations of the workforce. In actual practice compensation policies and structures are determined (a) unilaterally by employer in situations where employer could exploit the prevailing labour market situation, (b) jointly by management and workers union though collective bargaining (c) through consultations among the three partners in government, management and labour representatives under the minimum wages legislations (d) wage boards and pay commissions (e) courts through adjudication.

Process of Designing Compensation System:

Compensation is a systematic approach in providing monetary value to employees in exchange for work performed. Compensation may achieve several purposes assisting in recruitment, job performance, and job satisfaction[6].

Compensation will be perceived by employees as fair if based on systematic components. Various compensation systems have developed to determine the value of positions. These systems utilize many similar

6. Joseph, J. Martocchio, J. 2003 (Third Edition). Strategic Compensation system : A Human Resource Management Approach, Prentice Hell, 2003.

components including job descriptions, salary ranges/structure, and written procedures.

The components of a compensation system include :

- **Job Analysis** The process of analyzing jobs from which *job descriptions* are developed. Job analysis techniques include the use of interviews, questionnaires, and observation.
- **Job Descriptions** A critical component of both compensation and selection systems, job descriptions define in writing the responsibilities, requirements, functions, duties, location, environment, conditions, and other aspects of jobs. Descriptions may be developed for jobs individually or for entire job families.
- **Job Evaluation** A system for comparing jobs for the purpose of determining appropriate compensation levels for individual jobs or job elements. Job evaluation determine the relative value of compensable factors for the jobs in organizations. There are four main techniques: Ranking, Classification, Factor Comparison, and Point Method.
- **Pay Structures** Useful for standardizing compensation practices, most pay structures include several grades with each grade containing a minimum salary/wage and either step increments or

grade range. Step increments are common with union positions where the pay for each job is pre-determined through collective bargaining.

- **Salary Surveys** Collections of salary and market data, may include average salaries, inflation indicator s, cost of living indicators, salary budget averages. Companies may purchase results of surveys conducted by survey vendors or may conduct their own salary surveys. When purchasing the results of salary surveys conducted by other vendors, note that surveys may be conducted within a specific industry or across industries as well as within one geographical region or across different geographical regions.

- **Policies and Regulations** Compensation will be perceived as fair if it is comprised of a *system of components* developed to maintain internal and external al equity.

Compensation Plans – The steps to design compensation system or compensation plans

There are 12 steps to develop compensation plans:

Step 1 - Develop a program outline.

Step 2 - Designate an individual to oversee designing the compensation program.

Step 3 - Develop a compensation philosophy.

Step 4 - Conduct a job analysis of all positions.

Step 5 - Evaluate jobs.

Step 6 - Determine grades (Doing the job evaluation).

Step 7 - Establish grade pricing and salary range.

Step 8 - Determine an appropriate salary structure.

Step 9 - Develop a salary administration policy.

Step 10 - Obtain top executives; approval of the basic salary program.

Step 11 - Communicate the final program to employees and managers.

Step 12 - Monitor the program.

Compensation Plans

(1) Develop a Program Outline

(i) Set an objective for the program.

(ii) Establish target dates for implementation and completion.

(iii) Determine a budget.

(2) Designate an Individual to Oversee Designing the Compensation Program

(i) Determine whether this position will be permanent or temporary.

(ii) Determine who will oversee the program once it is established.

(iii) Determine the cost of going outside versus looking inside.

(iv) Determine the cost of a consultant's review.

(3) Develop a Compensation Philosophy

(i) Form a compensation committee (presumably consisting of officers or at least including one officer of the company).

(ii) Decide what, if any, differences should exist in pay structures for executives, professional employees, sales employees, and so on (e .g. hourly versus salaried rates, incentive-based versus, contingent pay).

(iii) Determine whether the company should set salaries at, above, or below market.

(iv) Decide the extent to which employee benefits should replace or supplement cash compensation.

(4) Conduct a Job Analysis of All Positions :

(i) Conduct a general task analysis by major departments. What tasks must be accomplished by whom?

(ii) Get input from senior vice presidents of marketing, finance, sales, administration, production, and other appropriate departments to determine the organisational structure and primary functions of each.

(iii) Interview department managers and key employees, are necessary, to determine their specific job functions.

(iv) Decide which job classifications should be exempt and which should be non-exempted.

(v) Develop model job descriptions for exempted and non-exempt positions and distribute the models to incumbents for review and comment; adjust job descriptions if necessary.

(vi) Develop a final draft of job descriptions.

(vii) Meet with department managers, as necessary, to review job descriptions.

(viii) Finalize and document all job descriptions.

(5) Evaluate Jobs

(i) Rank the jobs within each senior vice presidents and manager's department, and then rank jobs between and among departments.

(ii) Verify ranking by comparing it to industry market data concerning the ranking, and adjust if necessary.

(iii) Prepare a matrix organisational review.

(iv) On the basis of required tasks and forecasted business plans, develop a matrix of jobs crossing lines and departments.

(v) Compare the matrix with data from both the company structure and the industry wide marked.

(vi) Prepare flow charts of all ranks for each department for ease of interpretation and assessment.

(vii) Present data and charts to the compensation committee for review and adjustment.

(6) Determine Grades

(i) Establish the number of levels - senior, junior, intermediate, and beginner - for each job family and assign a grade to each level.

(ii) Determine the number of pay grades, or monetary range of a position at a particular level, within each department.

(7) Establish Grade Pricing and Salary Range

(i) Establish benchmark (key) jobs.

(ii) Review the market price of benchmark jobs within the industry.

(iii) Establish a trend line in accordance with company philosophy (i.e., where the company wants to be in relation to salary ranges in the industry).

(8) Determine an Appropriate Salary Structure

(i) Determine the difference between each salary step.

(ii) Determine a minimum and a maximum percent spread.

(iii) Slot the remaining jobs .

(iv) Review job descriptions.

(v) Verify the purpose, necessity, or other reasons for maintaining a position.

(vi) Meet with the compensation committee for review, adjustments, and approval.

(9) Develop a Salary Administration Policy

(i) Develop and document the general company policy.

(ii) Develop and document specific policies for selected groups.

(iii) Develop and document a strategy for merit raises and other pay increases, such as cost-of-living adjustments, bonuses, annual reviews, and promotions .

(iv) Develop and document procedures to justify the "policy (e.g., performance appraisal forms, a merit raise schedule).

(v) Meet with the compensation committee for review, adjustments, and approval.

(10) Obtain Top Executives' Approval of the Basic Salary Program

(i) Develop and present cost impact studies that project the expense of bringing the present staff up to the proposed levels.

(ii) Present data to the compensation committee for review, adjustment, and approval.

(iii) Present data to the executive operating committee (senior managers and officers) for review and approval.

(11) Communicate the Final Program to Employees and Managers

(i) Present the plan to the compensation committee for feedback, adjustment, review, and approval.

(ii) Make a presentation to executive staff managers for approval or change, and incorporate necessary changes.

(iii) Develop a plan for communicating the new program to employees, using slide shows or movies, literature, hand-outs, etc.

(iv) Make presentations to managers and employees. Implement the program.

(v) Design and develop detailed systems, procedures, and forms.

(vi) Work with HR information system staff to establish effective implementation procedures, to develop appropriate data input forms, and to create effective monitoring reports for senior managers.

(vii) Have the necessary forms printed .

(viii) Develop and determine format specifications for all reports.

(ix) Execute test runs on the human resources information system.

(x) Execute the program.

(12) Monitor the Program

(i) Monitor feedback from managers.

(ii) Make changes where necessary.

(iii) Find flaws or problems in the program and adjust or modify where necessary.

Compensation during economic crunch:

The economic crisis started in earnest in the summer of 2007. This was when the credit crunch first struck the American sub-prime housing market and quickly led to rapidly falling levels of liquidity in credit markets across the globe. After an interval of some months, a crisis that had been merely financial in scope struck the 'real' economy. This led to a global recession that many described as the worst since the 1930s, and to rising levels of unemployment and negative growth rates in many countries. Several financial institutions such as Bank of America and Citigroup were also 'bailed out' with public money, in line with the rationale that they were 'too big to fail'. Anger particularly centred on firms which had received public money, but in which executives continued to enjoy high levels of compensation. It was also felt that high salaries were unjustifiable in a time of recession, and that, in the financial sector particularly, the misalignment of reward and risk, the emphasis on short-termism, and the imbalance between executive compensation and firms' existing capital levels within reward systems had helped precipitate the recession.

In order to address these concerns, solutions were sought by policymakers. Several policies were developed at the national-level, but the view was widespread that in order to effectively tackle the problems associated with the issue, effective action was required at the international-level. The chapter will now outline the policies developed since the commencement of the crisis to regulate executive pay. As stated in section I, three different types of policies will be considered. These are (i) policies of a ' hard' form that seek to actually ' cap' levels of executive pay, (ii) policies that are ' softer' in their scope and that use techniques like the establishment of greater shareholder rights to determine compensation levels and the limiting of practices such as multi-year guaranteed bonuses, and (iii) international level policies.

Carrying out longitudinal analysis we find that an average bonus payments decrease considerably during crisis. The economic upturn in 2011 then leads to an increase in variable payments and total compensation to even above the pre-crisis level changes in bonus payments are negatively correlated one time. We fin considerable differences across employees with respect to changes in bonus payment[7].

The development of ' say on pay' policies on executive pay have been popular in many national contexts since the start of the crisis. 'Say on pay' policies involve giving shareholders within firms the right to vote on compensation levels of executives.

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7. Christian, Grund and Tanja, Walter, (2013), "Management Compensation and the economic crisis : longit udinal evidence from the German Chemical Sector, Discussion Paper No. 7435, May 2013.

The use of 'say on pay' policies in the U.S. developed further. In July 2009, the U.S. House of Representatives passed the 'Corporate and Financial Institution Compensation Fairness Act of 2009'. This bill allowed for 'say on pay' resolutions at all public institutions within the U.S., and also provided shareholders with the right to vote on' golden parachutes' (an agreement on benefits for executives in the event of termination of employment) for executives.

In India, Prime Minster Manmohan Singh issued a Charter to Indian industry that included a point about excessive levels of remuneration. In other national contexts, employers have autonomously agreed employers-led measures to regulate pay within specific sectors.

The first G20 summit of 2009 was held in London in April of that year. Rather than assembling finance ministers and central bank governors from the 20 G20 members as most previous summits had done, the London Summit involved the heads of state from the countries concerned. Three recommendations on the issue of executive pay were made:

- It was decided that' large financial institutions should ensure that their compensation frameworks are consistent with their long term goals and with, prudent risk-taking'. In order to fulfil this, it was stated that boards of directors and shareholders should ensure that firms and organizations had appropriate internal mechanisms in place to ensure the effective setting of compensation levels.

- It was decided that ' in order to promote incentives for prudent risk-taking, each financial review must review its compensation framework to ensure it follows sound practice principles developed by the FSF [now FSB]. These [sound practice principles] include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary systematically according to performance'.

- Finally, it was stated that ' prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices.

A second factor that implies a greater likelihood of the agreements being implemented success fully in G20 member countries is the degree of support that existed within the Governments of G20 member countries for an agreement on executive compensation prior to the summits.

Although disagreement was also evident regarding the best way to regulate the issue, a consensus at least existed that action was required. If one accepts the verdict of academic authorities, the existence of this consensus is likely to promote better implementation outcomes.

If the means used to monitor the implementation of G20 agreements on executive pay became more formalized then, it could lead to significantly better implementation outcomes at the national level. Monitoring mechanisms could be improved in various ways. Firstly, the production of ' action plans' on measures to tackle the issue of executive compensation would do much to focus minds on the series of policies that are requisite to adequately implement the principles agreed on executive compensation at London and Pittsburgh. Such 'action plans' would also provide good ' benchmarks' to appraise the implementations eventually affected. Were it to become demonstrable that a particular state had strayed from the measures agreed in their 'action plan', the level of recommendations for designing or improving pay for performance programs through the application of benavloral principles.

1. **Replace subjective performance measures with objective performance measures.** The traditional performance review or appraisal is based upon supervisor perceptions of an employee's performance rather than objective results. These perceptions are

influenced by many non-performance factors including employee 'likeability", employee 'busyness', personal prejudices, ease of management, conformance, previous mistakes or successes, and so on. Paying someone for 'being cooperative' fails to specify or direct the employee to produce true business results.

2. **Replace bonuses with pay for performance.** Bonuses are 'after-the- fact' discretionary payments to employees for a job well done. Though there is nothing wrong with this practice, it cannot improve or sustain employee performance since the employee is not told in advance what must be done to receive the payment. For bonuses to motivate employee performance the employee would have to be 'clairvoyant'.

3. **Replace annual performance measurement with more frequent measurement.** Requiring super visors to rate an employee's past year's performance is asking them to judge performance in the absence of any real data and then to somehow average employee performance over two hundred and fifty workdays. Performance measurement should be based on objective data and feedback should be provided to employees at least monthly.

4. **Replace large group measures with small team and personal performance measures.** Profit sharing and gain sharing plans are based on large group results. Paying employees on large group results is behaviourally unsound for two reasons. First, the employee typically has little or no control over the outcome. Large group results fail to specify what the individual employee should do. Second, the payment is based on the performances of hundreds or thousands of employees. This makes the payment uncertain and unrelated to the individual's personal effort.

5. **Replace broad financial measures with actionable measures.** No employee should be evaluated or paid for results he or she has little or no impact upon. Pay for performance plans that award payments to employees based upon broad financial results such as return on equity, return on assets, return to stockholders and the like are paying for organizational performance not employee performance.

6. **Replace unbalanced performance measurement plans with balanced plans.** One dimensional performance pay plans often yield unintended results. For example, sales commissions based on revenue generation may cause salespeople to sell things to people that can't pay, make promises that production can't keep, and

discount prices producing minimal margins. Once a performance measure is defined, the next question should be what adverse impact could a total employee focus on this result produce? If such an impact is possible, this outcome must also be measured and included in the measurement plan.

7. **Replace discretionary pay for performance plans with rule driven plans.** A successful pay for performance program must be as reliable and predictable as the traditional wage and salary program. A common mistake is to constantly change the program parameters and requirements. Employees will not invest time and effort in a program in which the measures, criteria, and pay potential change frequently and unpredictably.