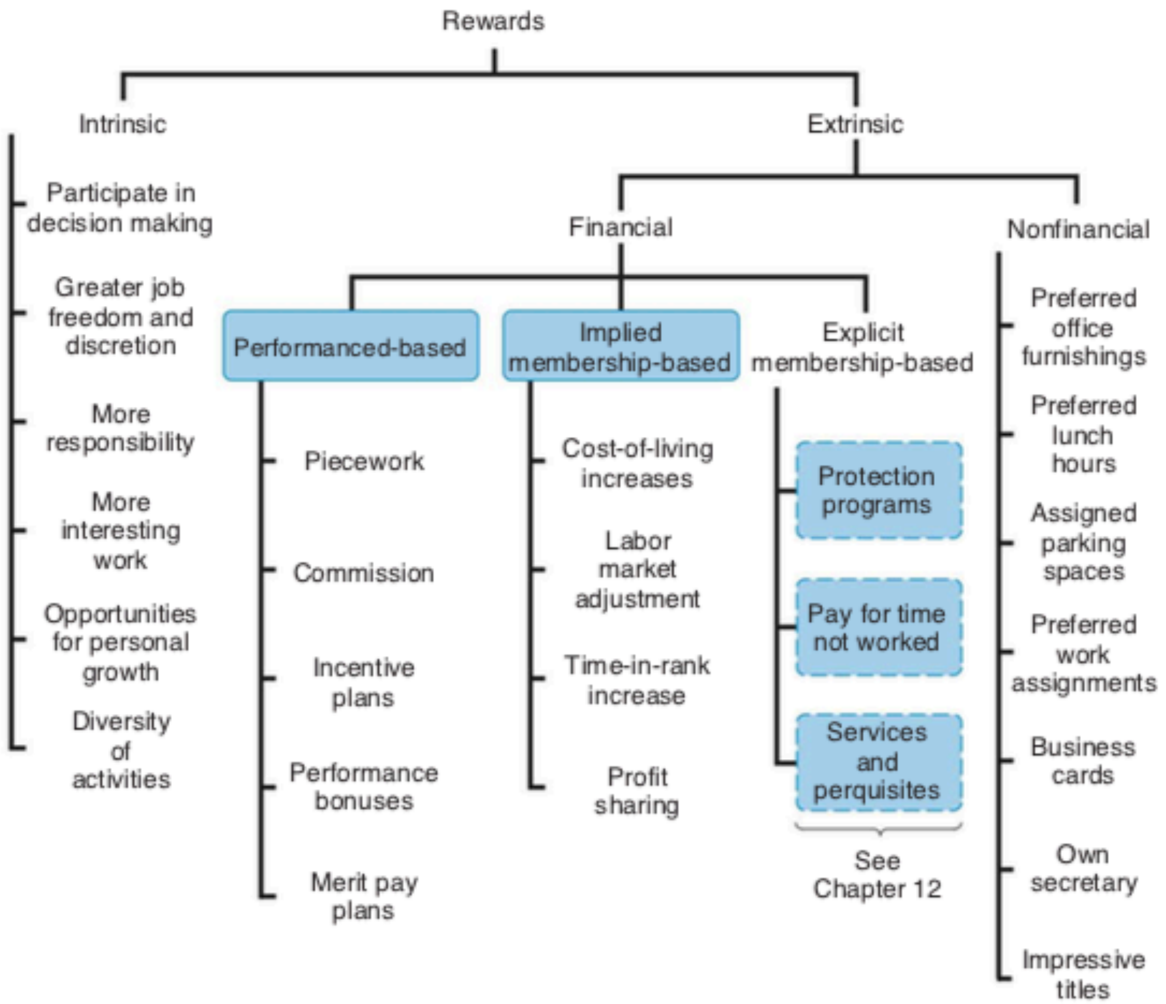
Compensation

Introduction

The most obvious reward employees receive from work is pay. However, rewards also include promotions, desirable work assignments, and a host of other less obvious payoffs—a smile, peer acceptance, work freedom, or a kind word of recognition.

Rewards Review



Intrinsic versus Extrinsic Rewards

Intrinsic rewards are the personal satisfactions one derives from doing the job. These are self-initiated rewards: pride in one's work, a sense of accomplishment, or enjoying being part of a work team.

Extrinsic rewards, in contrast, include money, promotions, and benefits. They are external to the job and come from an outside source, mainly management.

Structure of Rewards

Intrinsic rewards are the personal rewards or "warm fuzzy feelings" one gets from performing a job. Extrinsic rewards are financial and nonfinancial rewards such as money, promotions, and benefits. Notice that intrinsic rewards correlate well with the upper level needs and extrinsic rewards correlate well with the lower level needs.

Financial versus Nonfinancial Rewards

Rewards may or may not enhance the employee's financial well-being. Those that do, do so directly—through wages, bonuses, or profit sharing—or indirectly, through employer- subsidized benefits such as retirement plans, paid vacations, paid sick leaves, and purchase discounts.

Nonfinancial rewards present a variety of desirable extras for employees and organizations. These do not directly increase the employee's financial position, but make life on the job more pleasant.

Performance-Based versus Membership-Based Rewards

Organizations allocate rewards based on either performance or membership criteria.

Few organizations actually reward employees based on performance. Without question, the dominant basis for reward allocations in organizations is membership.

Performance-based rewards use commissions, piecework pay plans, incentive systems, group bonuses, merit pay, or other forms of pay for performance.

Membership-based rewards, on the other hand, include cost-of-living increases, benefits, and salary increases attributable to labor-market conditions.

Compensation Administration

Employees exchange work for rewards. Probably the most important reward, and the most obvious, is money. But not all employees earn the same amount of money. Why? The search for this answer moves us directly into the topic of compensation administration.

The goal of **compensation administration** is to design a cost-effective pay structure that will attract, motivate, and retain competent employees. The structure should also appear fair to employees. Fairness is a term that frequently arises in the administration of an organization's compensation program.

Government Influence on Compensation Administration

Fair Labor Standards Act: The **Fair Labor Standards Act (FLSA)** sets federal requirements for minimum wages, overtime pay, record keeping, and child labor restrictions. Nearly all organizations are covered by the FLSA, but not all employees are covered. The act identifies two primary categories of employees: exempt and nonexempt.

Exempt employees: Employees in positions that are exempt from most employee protection outlined in the Fair Labor Standards Act, especially overtime pay.

Nonexempt employees: Employees who are covered by the Fair Labor Standards Act, including overtime pay and minimum wage provisions.

The Civil Rights and Equal Pay Acts: The **Equal Pay Act of 1963** requires that organizations compensate men and women doing the same job in the organization with the same rate of pay.

Civil Rights Act:

- broader than Equal Pay Act

- prohibits discrimination on the basis of gender

- used to support comparable worth concept

- salaries established based on skill, responsibility, effort, and working conditions.

Job Evaluation and the Pay Structure

The essence of compensation administration is job evaluation and the establishment of a pay structure.

Job Evaluation

We stated that job analysis data could help develop job descriptions and specifications, as well as job evaluations. By job evaluation, we mean using job analysis information to systematically determine the value, or rank, of each job in relation to all jobs within the organization. The ranking that results from job evaluation is not an end in itself. It should be used to determine the organization's pay structure.

Other pay structure factors:

-labor market conditions

-collective bargaining

-individual skill differences

Isolating Job Evaluation Criteria

The heart of job evaluation is determining appropriate criteria to arrive at the ranking. It is easy to say that jobs are valued and ranked by their relative job worth, but ambiguity increases when we attempt to state what places one job higher than another in the job structure hierarchy. You should not expect the criteria to be constant across jobs. Because jobs differ, it is traditional to separate them into common groups.

Job Evaluation Methods

Three basic methods of job evaluation are currently in use: ordering, classification, and point methods.

Ordering Method: The **ordering method** (or ranking method) requires a committee—typically composed of both management and employee representatives—to arrange jobs in a simple rank order, from highest to lowest.

Classification Method: The **classification method** was made popular by the U.S. Civil Service Commission, now the Office of Personnel Management (OPM). The OPM requires that classification grades be established and published in what they call their general schedules. These classifications are created by identifying some common denominator—skills, knowledge, responsibilities—to create distinct classes or grades of jobs.

Point Method: HR develops a **point method** by breaking jobs down into categories such as education, skill, effort, responsibility and working conditions. Points are assigned to each category based on the importance of the criteria to successful performance of the job. Points may be weighted more heavily if increased education, skill or experience are required for the position. Pay grades or ranges are assigned to jobs based on the total number of points. The point method offers the greatest stability of the four approaches presented.

Establishing the Pay Structure

Once the job evaluation is complete, the data generated become the nucleus of the organization’s pay structure. This means establishing pay rates or ranges compatible with the ranks, classifications, or points arrived at through job evaluation. Any of the three job evaluation methods can provide the necessary input for developing the organization’s overall pay structure.

Compensation Surveys: Many organizations use surveys to gather factual information on pay practices within specific communities and among firms in their industry. They use this information for comparison purposes. Information is often collected on associated employee benefits as well.

Wage Curves: After the compensation committee arrives at point totals from job evaluation and obtains survey data on what comparable organizations are paying for similar jobs, a wage curve can be fitted to the data. A separate wage curve can be constructed based on survey data and com- pared for discrepancies. A completed wage curve tells the compensation committee the average relationship between points of established pay grades and wage base rates.

The Wage Structure: It is only a short step from plotting a wage curve to developing the organization's **wage structure**. Jobs similar in terms of classes, grades, or points are grouped together. the result is a logical hierarchy of wages. The more important jobs are paid more; and as individuals assume jobs of greater importance, they rise within the wage hierarchy. Jobs may also be paid in accordance with knowledge- or competency-based pay.

External Factors Also Influence Pay Structure:

When determining the wage structure, HR must also consider external factors which are:

Geographic Differences: Cost of labor is a function of supply and demand, among many other factors.

Labor Supply: When unemployment rates are low, employers must work harder to attract qualified workers.

Competition: When setting a policy on how to react to competition wages, HR professionals have three choices:

1. *Match* the competition: by paying the market or going rate for labor.
2. *Lead* the competition by paying higher wages than competing employers.
3. *Lag* the market by paying slightly less than the prevailing levels in the market place.

Cost of Living: Inflation raises the price of consumer goods and reduces the buying power of wages in real terms. As determined by Consumer Price Index (CPI).

Collective Bargaining: The major function of most unions or collective bargaining units is to negotiate for the wages of its members.

Communicating with Employees: No matter how the wage structure is developed, employees must know how the system is derived.

Special Cases of Compensation

Subsequently, more organizations are moving to varied themes of pay for performance. These may include incentive compensation plans, and competency- and team-based compensation.

Incentive Compensation Plans: In addition to the basic wage structure, organizations sincerely committed to developing a compensation system designed around performance should consider incentive pay. Incentives can be paid based on individual, group, or organization-wide performance—a pay-for-performance concept.

Individual Incentives: **Individual incentive plans** pay off for individual performances. Popular approaches include merit pay, piecework plans, time-savings bonuses, commissions, and stock options.

Group Incentives: Each individual incentive option we describe can also work for groups. That is, two or more employees can be paid for their combined performance. **Group incentives** make the most sense when employees' tasks are interdependent and thus require cooperation.

Advantages:

- Focuses the group on specific performance targets.

- Since rewards are controllable by individuals, the programs can be very motivational.

- The program can be integrated with other corporate initiatives and leads to improved communication and employee relations.

Disadvantages:

- Can be costly to install and administer.

- De-emphasizes individual performance, which can result in excessive peer pressure.

- Requires open communication with employees on costs, profitability, etc. If the performance targets are not carefully selected, adverse results may occur.

Organization-Wide Incentives: **Organization-wide incentives** aim to direct the efforts of all employees toward achieving overall organizational effectiveness. This type of incentive produces rewards for all employees based on organization-wide cost reduction or profit sharing. One of the best-known organization-wide incentive systems is the **Scanlon Plan**. It seeks cooperation between management and employees through sharing problems, goals, and ideas. Another incentive plan called **IMPROSHARE**, a contraction of Improving Productivity through Sharing, uses a mathematical formula to determine employees' bonuses.

Paying for Performance: **Pay-for-performance programs** compensate employees based on a performance measure.

A recent extension of the pay-for-performance concept, **competency-based compensation**, is used in such industries as diverse as healthcare and energy production. A competency-based compensation program pays and rewards employees on their skills, knowledge, or behaviors. These competencies may include such behaviors and skills as leadership, problem solving, decision making, or strategic planning.

In competency-based pay plans, these preset levels are called **broad-banding** which is pre-set pay levels that determine what people are paid based on their type and level of competency.

Team-Based Compensation: When organizations group employees into teams and empower them to meet goals, teams reap the benefits of their productive effort. That is, **team-based compensation** plans are tied to team-based performance. Under a team-based compensation plan, team members who work on achieving— and in many cases, exceeding—established goals often share equally in the rewards. It requires several key components:

- clarity of team purpose and goals

- ability of the team to obtain needed resources

- effective team communication skills and trust

Executive Compensation Programs

Executive compensation has become one of HR's most controversial issues.

Salaries of Top Managers

- executive pay can run 400 times higher than that of the average worker.

- 2008 saw a decline in exec compensation, mostly due to economic and political forces.

- competition for executive talent raises the price of hiring an executive.

- high salaries can be a motivator for executives and lower-level managers.

Supplemental Financial Compensation: Most of the CEO compensation packages we've discussed so far include their total compensation—base salary plus bonuses and stock options. Bonuses and stock options dramatically increase the total compensation that executives receive.

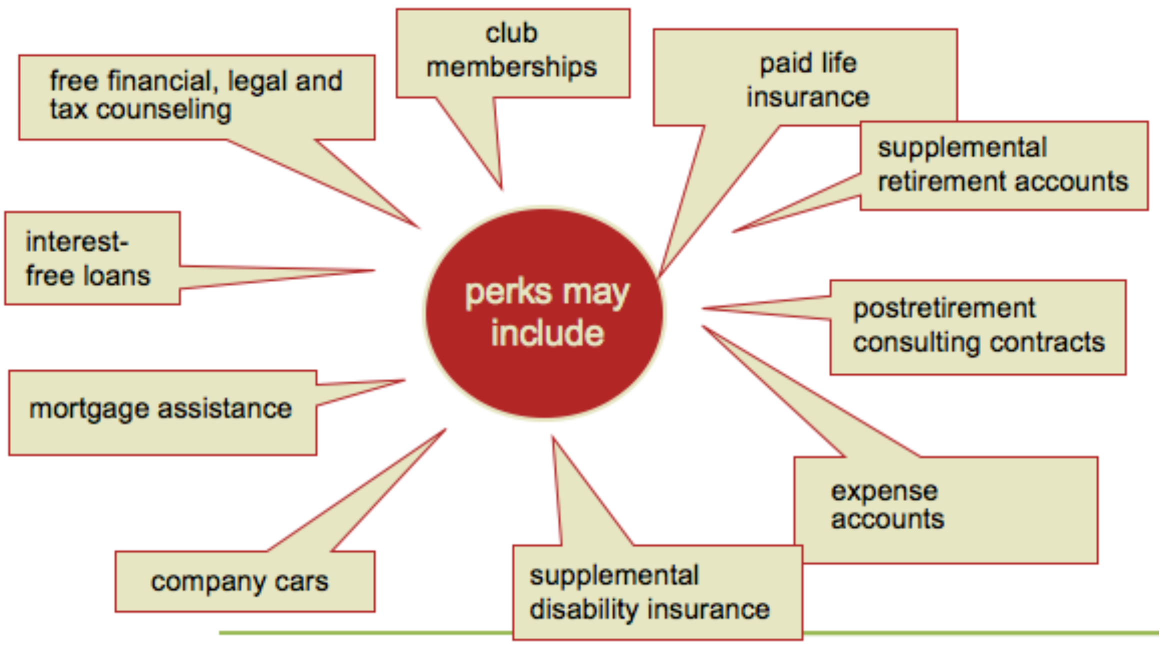
deferred bonuses – paid to executives over extended time periods, to encourage them to stay with the company.

stock options – allow executives to purchase stock in the future at a fixed price.

hiring bonuses – compensate for the deferred compensation lost when leaving a former company.

Supplemental Nonfinancial Compensation: Perquisites

Executives are frequently offered a variety of perquisites not offered to other employees. The **perquisites**, or **perks** may include:



A benefit for top executives is the **golden parachute**. **Golden parachutes** protect executives when a merger or hostile takeover occurs by providing severance pay or a guaranteed position.

International Compensation

International compensation packages generally utilize the “balance-sheet approach,” using these four factors:

base pay: the pay of employees in comparable jobs at home.

differentials: compensation given to offset higher costs of living abroad.

incentives: inducements given to encourage employees to accept overseas assignments.

assistance programs: payment for expenses involved in moving a family abroad and in providing some services overseas.

HR needs to understand the statutory requirements of each country.

Summary

1. **Explain the various classifications of rewards.** Rewards can be classified as (a) intrinsic or extrinsic, (b) financial or nonfinancial, or (c) performance-based or membership-based.

2. **Discuss why some rewards are considered membership-based.** Some rewards are membership-based because one receives them for belonging to the organization. Employee benefits are an example of membership-based rewards, in that every employee receives them regardless of performance levels.

3. **Define the goal of compensation administration**. Compensation administration seeks to design a cost-effective pay structure that will not only attract, motivate, and retain competent employees, but also seem fair to them.

4. **Discuss job evaluation and its three basic approaches.** A job evaluation systematically determines the value of each job in relation to all jobs within the organization. The three basic approaches to job evaluation are (1) the ordering method, (2) the classification method, and (3) the point method.

5. **Explain the evolution of the final wage structure.** The final wage structure evolves from job evaluation input, compensation survey data, and the creation of wage grades.

6. **Describe competency-based compensation programs.** Competency-based compensation views employees as a competitive advantage in the organization. Compensation systems are established in terms of employee knowledge, skills, and demonstrated behaviors. Possession of these three factors is evaluated and compensated according to a broad-banded salary range established by the organization.

7. **Discuss why executives receive significantly higher salaries than other employees in an organization.** Executive compensation is higher than that of rank-and-file personnel and also includes other financial and nonfinancial benefits not otherwise available to operative employees. This is done to attract and retain executives and motivate them to higher performance levels.

8. **Identify the balance-sheet approach to international compensation**. The balance-sheet approach to international compensation takes into account base pay, differentials, incentives, and assistance programs.