

## **COURSE: REWARD MANAGEMENT**

### **LECTURE 6: CONCEPT OF COMPENSATION**

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#### **Lecture learning outcomes:**

#### **At the end of the lecture, you will be able to:**

- i. Understand the concept of compensation
- ii. Discuss objectives of compensation
- iii. Examine the principles of compensation

#### **Compensation Management**

The term compensation represents the exchange between employees and organization, both gives something in return for something else. In the past, the compensation issues were often confidential and governed by individual employer's preferences and choices. However, in today's competitive world the compensation policies are more transparent and the employees take their own choices based on the compensation package. Thus, balancing the cost of compensation and retaining the employees have become the most important priority for the organization (Bhattacharyya 2009).

Compensation is the remuneration received by an employee in returns of their contribution to the organization. The compensation management is an organized practice which is important for balancing the work and employee relationship by providing monetary and non-monetary compensation to employees. Compensation includes all form of pay given to the employees which arise from the employment. The one of the strapping feature of the organizations is compensation management and they used it to attract and retain the most important and worthy assets. The compensation management is considered to be a complex process which requires accuracy and precision and if not carried out properly may lead to employees' dissatisfaction. An ideal compensation policy motivates the employees to work harder and with more determination. It also helps the organizations to set the standards for job that it is related, realistic and measurable. Compensation policies should have a sound integration with practices of HRM. One of the key functions of compensation management of any company is to create a hearty competition among the employees in order to attain more efficiently and provide growth opportunities to its employees (Khan, Aslam, Lodhi, 2011).

In today's intensely competitive and global marketplace, competitive advantage lies not just in differentiating a product or service or in becoming the low-cost leader but in also being able to tap the company's special skills or core competencies. Therefore, skilled and efficient employees of a company are now considered as one of the core competencies of the company. Especially for power industry, skilled, efficient and motivated employees are must which requires specialized, technical and scientific knowledge and expertise. To attain such objectives HR plays a vital role and one of

the most used tools by HR in order to ensure motivation for each and every employee is a satisfactory “Compensation Package”.

Employees need to be compensated for their efforts based on volume of time or volume of production. Compensation refers to all forms of financial rewards received by employees. It arises from their employment. It occupies an important place in the life of the employee. It is a considerable cost to the employer. Compensation dissatisfaction can lead to absenteeism, turnover, job dissatisfaction, low performance, strikes and grievances. The majority of labor-management disputes relate to compensation. Compensation is a key factor in attracting and keeping the best employees and ensuring that the organization has the competitive edge in an increasingly competitive world. The Compensation Management component enables to differentiate between the remuneration strategies and those of competitors while still allowing flexibility, control and cost effectiveness. It provides a toolset for strategic remuneration planning that reflects the organization culture and pay strategies and it empowers line managers within a framework of flexible budget control. Compensation Management allow to control bottom-line expenditures and offer competitive and motivating remuneration, be it fixed pay, variable pay, stock options, merit increases, or promotion – in other words, total compensation.

Compensation has an impact on attracting, retaining and motivating the executive. Disparities in compensation pattern often lead to dissatisfaction among executives. To make the executives comfortable to the extent possible and further to keep them from turning hostile, private companies have been giving in recent years, bigger and more frequent rises in salaries. Companies have started looking at executive compensation more proactively so that they can expect better performance from them.

The compensation system results from the allocation and transfer of a portion of the income of an organization to its employees for their monetary claims on goods and services. Monetary claims on goods and services are wages or salaries paid to an employee in the form of money. As a medium of exchange, money enables an employee to purchase goods and services available in the marketplace. Wages and salaries in the form of money may be subdivided further into payments earned and acquired at the present time and payments earned but not acquired until some future time-deferred payments.

Compensation or reward management is concerned with the formulation and implementation of strategies and policies which are to reward people fairly, equitably and consistently in accordance with their value to the organizations and to help the organization to achieve its strategic goals. It deals with the design, implementation and maintenance of reward systems which aim to meet the needs of both the organization and its shareholders.

Compensation could be defined as the reward of any work or service offered by an individual to any organization or institution. To some, compensation may reflect the value of their personal skills and abilities, while to others it may refer to be return on the educational qualification or the training they have acquired. To some, it may be their worth in specific role or a job, based on their qualification, training, skills and expertise that they possess. The form of compensation, the type

of compensation and the disbursement pattern of the compensation thus they become a part of employment agreement.

In other words, compensation is a systematic approach to providing monetary value to employees in exchange for work performed. Compensation may achieve several purposes assisting in recruitment, job performance, and job satisfaction. Compensation is a tool used by management for a variety of purposes to further the existence of the company. Compensation may be adjusted according to the business needs, goals, and available resources.

Compensation refers to a wide range of financial and non-financial rewards to employees for their services rendered to the organization. It is paid in the form of wages, salaries and employee benefits such as paid vacations, insurance maternity leave, free travel facility, retirement benefits etc., Monetary payments are a direct form of compensating the employees and have a great impact in motivating employees.

Compensation management has become one of the issues both for employees and employers around the world due to its importance. Naturally, employees want to get more remuneration for their work as where employers want to pay as minimum as they can. So regarding the compensation there is a conflict between employees and employers in many of the organizations.

According to Cascio (1995) the “Compensation includes direct cash payments and indirect payments in form of employees benefits and incentives to motivate employees to strive for higher levels of productivity”.

According to Milkovitch and Newman (2005) “Compensation is all forms of financial returns, tangible services and benefits employees receive as part of an employment relationship.” The phrase “financial returns” refers to an individual's base salary, as well as short- and long-term incentives. “Tangible services and benefits” are such things as insurance, paid vacation and sick days, pension plans, and employee discounts.

Compensation is the remuneration an employee receives for his or her contribution to the organization. It occupies an important place in the life of employee. His or her standard of living, status in the society, motivation, loyalty and productivity depend upon the remuneration he or she receives. For the employer too, employee compensation is significant because of its contribution to the cost of production.

Compensation may be used to:

- Recruit and retain qualified employees.
- Increase or maintain morale/satisfaction.
- Reward and encourage peak performance.
- Achieve internal and external equity.
- Reduce turnover and encourage company loyalty.
- Modify (through negotiations) practices of unions.

## Nature and Purpose of compensation management

The basic purpose of compensation management is to establish and maintain an equitable reward system. The other aim is the establishment and maintenance of an equitable compensation structure, i. e, an optimal balancing of conflicting personnel interests so that the satisfaction of employees and employers is maximized and conflicts minimized. The compensation management is concerned with the financial aspects of needs, motivation and rewards. Managers, therefore, analyze and interpret the needs of their employees so that reward can be individually designed to satisfy these needs. For it has been rightly said that people do what they do to satisfy some need. Before they do anything, they look for a reward or pay-off.

- From individual standpoint -remuneration is a major source of an individual's purchasing power. It determines his or her status, prestige & worth in society.
- From enterprise standpoint- compensation is a crucial element in the cost of production, which is expected to permit adequate profits leading to increase in new capital, expansion production, and capacity.
- From national point of view –dissatisfied work force hampers equitable distribution of aggregate real income among various group involved .it causes inflation.

## Aims of Compensation Management

The following are the important aims of compensation management.

- i. Reward people according to what the organization values and wants to pay for.
- ii. Reward people for the value they create.
- iii. Reward the right things to convey the right message about what is important in terms of outcomes and behaviors.
- iv. Develop a performance culture.
- v. Motivate people and obtain their commitment and engagement.
- vi. Help to attract and retain the high-quality people the organization needs.
- vii. Create total reward processes which recognize the importance of both financial and non-financial rewards.
- viii. Align reward practices with both business goals and employee values and
- ix. Operate in ways which are as follows :

**Fair:** A fair reward system is one in which people are treated justifiably in accordance with what is due to them and their value to the organization. Fairness means that the reward system operates according to the principles of distributive and procedural justice. Distributive justice is provided to people what they believe that rewards have been distributed in accordance with the value of their contribution, that they receive what was promised to them and that they get what they need. Procedural justice conforms to the ways in which managerial decisions are made. The following are the five factors which affect procedural justice:

The viewpoint of employees is given proper consideration.

- Personal bias towards employees is suppressed.
- The criteria for decisions are applied consistently to all the employees.

- Employees are provided with early feedback, about the outcome of decision.
- Employees are provided with adequate explanations of why decisions have been made

**Equity:** Equity is achieved when people are rewarded appropriately in relation to others within the organization.

Equitable reward processes ensure that relativities between jobs are measured as objectively as possible and that equal pay is provided to employees for their work of equal value.

**Consistent:** Consistent means decisions on pay should not differ randomly among different people or at different times.

**Transparent:** Transparency means that people understand how reward processes operate and how they are affected by them. The reasons for any decisions are explained to them at the time they are made.

**A Sound Compensation Structure achieves the following objectives :**

- To attract manpower in a competitive market.
- To control wages and salaries and labour costs by determining rate change and frequency of increment.
- To maintain satisfaction of employees by exhibiting that remuneration is fair adequate and equitable.
- To induce and reward improved performance, money is an effective motivator.

#### **For employees**

1. Employees are paid according to the requirements of their jobs, i.e., highly skilled jobs are paid more compensation than low skilled jobs. This eliminates inequalities.
2. The chances of favoritism (which creep in when wage rates are assigned) are greatly minimized.
3. Job sequences and lines of promotion are established wherever they are applicable.
4. Employees' morale and motivation are increased because of the sound compensation structure.

#### **To Employers**

1. They can systematically plan for and control the turnover in the organization.
2. A sound compensation structure reduces the likelihood of friction and grievances over remuneration
3. It enhances an employee's morale and motivation because adequate and fairly administered incentives are basic to his wants and needs.
4. It attracts qualified employees by ensuring and adequate payment for all the jobs

In addition, Bhattacharay (2009) provides the following objectives of compensation or wages as given below:

**Equity** The first category is equity which may take several forms. It include income distribution through narrowing of inequalities, increasing the income of lowest paid employees, protecting real wages (purchasing power), and the concept of equal pay for work of equal values. Compensation management strives for internal and external equity. Internal equity requires pay related to the worth of similar job so that similar job gets similar pay. External equity means paying worker what other firms in the labor market pay comparable workers. Compensation differentials, based on differences in skills or contribution, are all to the concept of equity.

### **Efficiency**

The objective of efficiency are reflected in attempts to link a part of wages to productivity or profit, group or individual performance, acquisition and application of skills, and so on. Arrangement to achieve efficiency may also be seen as being equitable (if they fairly reward performance) or inequitable (if the reward is viewed as unfair).

### **Macro-economic Satiability**

It can be achieved through high employments level and low inflation. For instance, an inordinately high minimum wages would have an adverse impact on levels employment, tough at what level these consequences would occur is a matter of debate. Although compensation policies influence macro-economic stability and contribute to the balanced and sustainable economic development

### **Efficient Allocation of Labor**

The efficiency allocation of labor in the labor market implies that employees will move to wherever they receive a net gain. Such movement may be form one geographical location to another or form one job to another (within or outside an enterprise). The provision or availability of financial incentive causes such movement.

### **Motivating the Employees**

Employees may have talent but they will not be motivated to use their talent unless they know that they will be rewarded duly for their contribution towards organizational objectives or be punished for not contributing as per the demands of the job.

### **Acquired Qualified**

Employees Compensation needs to be high enough to attract applicants. Pay levels must respond to supply and demand of workers in the labor market since employers compete for workers.

### **Retain Current Employees**

Employees may quit when compensation levels are not competitive resulting in higher turnover. Therefore, one of the important objective of Compensation Management is retaining the human capital or talent of the organization.

### **Reward Desired Behavior**

Pay should reinforce desired behavior and act as incentive for those behaviors to occur in future.

### **Control Cost**

A rational compensation system helps the organization obtain and retain workers at reasonable cost.

### **Comply with Legal Regulations**

A sound wage and salary system considers the legal challenges imposed by the government and ensures the employers compliance.

### **Facilitate Understanding**

The Human Resource specialists, operating managers and employees should easily understand the compensation management.

### **Further Administrative**

Efficiency Wages and salary programs should be designed to be managed efficiently, making optimal use of HRIS i.e. Human Resource Information System

### **Principles of compensation**

- Differences in pay should be based on differences in job requirements.
- Wage and salary level should be in line with those prevailing in the job market.
- Follow the principle of equal pay for equal work.
- Recognize individual differences in ability and contributions.
- The employees & trade unions should be involved in establishing wage rates. The wages should be sufficient to ensure for the worker and his family reasonable standard of living.
- There should be a clearly established procedure for redressal of grievances concerning wages.
- The wage & salary structure should be flexible. Wages due to employees should be paid correctly & promptly.
- A wage committee should review and revise wages from time to time.

### **Principles of compensation formulation (Jain, 2014):**

1. The organization should have a unambiguous plan to determine differential pay levels in terms of different job requirements involving varied skills, exertion, responsibility and working conditions.
2. An attempt should be made to keep the common level of wages and salaries of the organization in line with that obtained in the labor market.
3. Adequate attention should be taken to distinguish people from the jobs. Although people are paid in terms of rate embodied in specific jobs, some exceptions should be allowed in the cases of professional and executive personnel by paying them in terms of their abilities and contributions.

4. The care should be taken irrespective of individual considerations to ensure equal pay for equal work.
5. There should be a plan to adapt an unbiased measure for identifying individual differences in capacity and contribution in the form of rate ranges within the grade increments, wages incentive schemes and a system of job promotion.
6. There should be proper procedure for handling the wage grievances in the organization.
7. Adequate care should be taken to inform the employees and the union, if any, about the procedure followed in determining wage rates. There are no confidential wages, and the employees should have a clear understanding of their wage or salary structure. This enhances employee satisfaction with wages. There are certain guiding principles which provide the foundation for effective reward management.

### **Determinants of Compensation:**

Compensation is the only HR activity which has its impact on all other functions regarding personnel. The different activities such as job analysis, job evaluation, performance appraisal among others determine compensation. Recruitment and selection are dependent upon wages and salaries offered to prospective employees. There is a close relationship between performance appraisal and remuneration. This is particularly true in cases where 'payment by results' schemes exist. Incentive payments depend on the employee performance which needs to be carefully assessed.

Following are the determinants of compensation in an organization:

#### **Labour Market**

Demand for and supply of labour influence wage and salary fixation. A low wage may be fixed when the supply of labour exceeds the demand for it. A higher wage will have to be paid when the demand exceeds supply, as in the case of skilled labour. Many times due to excessive unemployment is being juxtaposed with shortage of labour. While unskilled labour is available in plenty, there is a shortage of technicians, computer specialists and professional managers. High remuneration to skilled labour is necessary to attract and retain them. But exploitation of unskilled labour, for instance, paying niggardly wages because it is available in plenty, is unjustifiable. The Minimum Wages Act in countries are meant to prevent this kind of exploitation.

#### **Productivity of Labour:**

It also influences wage fixation. Productivity can arise due to increased effort of the worker, or as a result of the factors beyond the control of the worker such as improved technology, sophisticated machines and equipment, better management, and the like. Greater effort of the worker is rewarded through piece-rate or other forms of incentive payments. This form of productivity, due to individual effort, cannot form a criterion of general wage payments.

Productivity arising from advanced technology and more-efficient methods of production will influence wage fixation. While productivity can be measured in terms of any one of the several factors such as capital equipment, materials, fuel and labour, what matters most is labour productivity. It is the relationship between the input of labour measured in man-hours and the

output of the entire economy, or of a particular industry or plant measured in terms of money or in physical terms. It may be stated that productivity has only subordinate role in wage fixation. It can, at best, help determine fair wages.

### **Cost of Living:**

Next in importance to labour market is the cost of living. This criterion matters during periods of rising prices and is forgotten when prices are stable or falling. The justification for cost of living as a criterion for wage fixation is that the real wages of workers should not be allowed to be whittled down by price increases. A rise in the cost of living is sought to be compensated by payment of Dearness Allowance, basic pay to remain undisturbed.

### **Labour Unions:**

The presence or absence of labour organizations sometimes determines the wages paid to employees. Employers in non-unionized factories enjoy the freedom to fix wages and salaries as they please. Because of large-scale unemployment, these employers hire workers at little or even less than legal minimum wages.

### **The Economy:**

The last external factor that has its impact on wage and salary fixation is the state of the economy. While it is possible for some organizations to thrive in a recession, there is no question that the economy affects remuneration decisions. For example, a depressed economy will probably increase the labour supply. This, in turn, should serve to lower the going wage rate.

### **Internal Factors:**

**Business strategy** -The overall strategy which a company pursues should determine the compensation to its employees. Where the strategy of the enterprise is to achieve rapid growth, remuneration should be higher than what competitors pay.

**Job evaluation** -helps to establish satisfactory wage differentials among jobs. Performance appraisal helps award pay increases to employees who show improved performance. Performance is always rewarded with a pay increase. Rewarding performance motivates the employee to do better. Managements prefer performance to effect pay increases but unions view seniority as the most objective criterion for pay increases.

**Experience** -makes an employee gain valuable insights and should therefore be rewarded.

**Potential** -is useless if it is never realized. Yet, organizations do pay some individuals based on their potential.

### **Individual Factor:**

An employee as individuals worries about compensation worth, while compensation differentiation depends on sex, skill, experience, and level of competition. In designing the compensation structure, individual skill, knowledge, expertise, attitude, sex, work environment and experience play an important role to fix the level of job to meet the job description regarding

personality of an individual. Similarly the creativity, innovation, imitation desire to be used on specific job also matters. These factors determine the worth of an employee for this specific job and help in designing wage/salary differentiation.

### **Organizational Factor:**

Organizational earning depends on productivity of employee and their efficiency, this measures the company's ability to pay. Besides this the size and technology required to perform any task and span of control depending upon the size and nature of organization. The capacity to pay also depends upon the financial strength of the company, size, nature and number of level and cost of technology being used in the organization.

### **Competitive Factor:**

The level of pay will depend on the mission and vision of the organization. That means whether the organization is willing to lead, develop competitiveness or meet the changing environment. This help to decide the datum for the minimum and maximum rangers to the entry level, middle level or higher level or to retain the old talent.

### **Product-Cost Factor:**

It is a process of converting the job price into a monetary award to the employee performing or going to perform that job. The process, thus, covers job analysis, job pricing consideration, government legislation and organizational capacity to pay and developing pay packages to different levels of employees.

### **Other Factors:**

Besides the above common factors affecting design, the following considerations need careful analysis in finalizing wages or salary structure for effective administration and management:

- i. Company objective and mission
- ii. Marketing rates and trends to fulfill the objective of external equity.
- iii. The organizational ability to pay maintains the commitments and demand. elasticity to view the future conditions of market values.
- iv. Cost of living in the region.
- v. Productivity linked performance.
- vi. Strengths of unions and their pressure on compensation.
- vii. Company's goodwill and images in the market.
- viii. Various government legislations to protect the interests of the employees. ix. Tribunal's judgments on compensation disputes.

### **Compensation Policy**

Compensation policy and practices are viewed as an important factor or a role of HRM in ensuring its survival and growth. It is a written document, rather a commitment of the organization to ensure the concept of equity, easing out payment, providing opportunities to grow or earn more as to make it cost effective. From employee's point of view, compensation determines their standard of

leaving. Compensation policy is therefore an important commitment of the company and obligation of the government to recognize the need of developing this community. It is a written document of any HRM of the company, which reflect the intension and objective of the company to hire or acquire, maintain and retain its employees.

A company policy has to be transparent to highlight the compensation determination criteria for future growth and increments /promotions, compensation to bear the burden of inflation and appropriate measures to provide compensation relating to the injury or accident at work, disablement and retirement benefit plans. It should also cover the settlement process of any disputes or dissatisfactions and the expectation of unions.

### **Dimensions of Compensation Policy:**

A sound compensation policy has different dimensions to be determined while fixing the wages and salaries including other allowances and incentives.

### **Following are dimensions of compensation policy:**

**Ability to Pay:** Wage increases should be given by those organizations which can afford them. Companies that have good sales and therefore high profits tend to pay higher wages than those which are running at a loss or earning low profits because of the high cost of production or low sales. In the short run, the economic influence of the ability to pay is practically nil. All employers, irrespective of their profits or losses, must pay no less than their competitors and need pay no more if they wish to attract and keep workers. In the long run, the ability to pay is very important. During times of prosperity, employers pay high wages to carry on profitable operations because of their increased ability to pay. But during a period of depression, wages are cut because of the shortage of funds.

**Supply and Demand of Labour:** Wages and salaries are affected by the market conditions of supply and demand. If the supply of particular labour skills is scarce, employers may offer higher wages. If the supply is excessive, lower wages are usually given. Similarly, if there is a great demand for labour expertise, wages rise, but if the demand for a manpower skill is minimal, wages will be relatively low. The supply and demand compensation criterion is very closely related to the prevailing pay, comparable wage and ongoing wage concepts are determined by immediate market forces and factors.

**Prevailing Market Rate:** This is also known as the comparable wage or going wage rate and is the most widely used criterion. An organization's compensation policies generally tend to conform to the wage rate payable by the industry and the community. This is done for several reasons. First, competition demands that competitors adhere to the same relative wage level. Second, various government laws and judicial decision make the adoption of uniform wage rates an attractive proposition. Third, trade unions encourage this practice so that their members can have equal pay for equal work and geographical differences may be eliminated. Fourth, functionally related firms in the same industry require essentially the same quality of employees with the same skills and experience. This results in a considerable uniformity in wage and salary rates. Finally, if the same or about the same general rates of wages are not paid to the employees as are paid by the

organization's competitors, it will not be able to attract and maintain sufficient quantity and quality of manpower. Belcher and Aitcheson observe: "some companies pay on the high side of the market in order to obtain goodwill or to leisure an adequate supply of labour while other organizations pay lower wages because economically they have to or by lowering hiring requirements they can keep jobs adequately manned."

**Cost of Living:** The cost of living pay criterion is usually regarded as an automatic minimum equity pay correction. This criterion calls for pay adjustments based on increases or decreases in an acceptable cost of living index. In recognition of the influence of the cost of living, "escalator clauses" are written into labour contracts. When the cost of living increases, workers and trade unions demand adjusted-wages to offset the erosion of real wages. However, when living costs are stable or decline, the management does not resort to this argument as a reason for wage reduction.

**The Living Wage:** The living wage criterion means that wages paid should be adequate to enable an employee to maintain himself and his family at a reasonable level of existence. However, employers do not generally favour using the concept of living wages as a guide to wage determination because they prefer to base the wages of an employee on his contribution rather than on his need. Also they feel that the level of living prescribed in a worker's budget is open to argument since it is based on subjective opinion.

**Productivity:** Productivity is another criterion and is measured in terms of output per man-hour. It is not due to labour efforts alone. Technological improvements, better organization and management, the development of better methods of production by labour and management, greater ingenuity and skill by labour are all responsible for the increase in productivity. Actually productivity measures, the contribution of all the resource factors-men, machines, methods, materials and management. No productivity index can be devised which will measure only the productivity of a specific factor of production. Another problem is that productivity can be measured at several levels-job, plant, industry on national economic level. Thus, although theoretically it is a sound compensation criterion, operationally many problems and complications arise because of measurement and conceptual issues.

**Union Bargaining Power:** Trade unions do affect the rate of wages. Generally, the stronger and more powerful the trade union, then there will be higher wages. A trade union's bargaining power is often measured in terms of its membership, its financial strength and the nature of its leadership. A strike or threat of a strike is the most powerful weapon used by it. Sometimes, trade unions force wages up faster than increases in productivity would allow and become responsible for unemployment or higher prices and inflation. However, for those remaining on the pay roll, a real gain is often achieved as consequence of a trade union's stronger bargaining power.

**Job Requirements:** Generally, the more difficult a job, the higher are the wages. Measures of a job difficulty are frequently used when the relative value of one job to another in an organization is to be ascertained. Jobs are graded according to the relative skill, effort, responsibility and job conditions required.

**Psychological and Social Factors:** These factors determine in a significant measure, how hard a person will work for the compensation received or what pressures he will exert to get his

compensation increased. Psychologically, persons perceive the level of wages as a measure of success in life; people may feel secure, have an inferiority complex, seem inadequate or feel the reverse of all these. They may or may not take pride in their work or in the wages they get. Therefore, these things should not be overlooked by the management in establishing wage rates. Sociologically and ethically, people feel that equal work should carry 'equal wages', that wages should be commensurate with their efforts, that they are not exploited and that no distinction is made on the basis of caste, colour, sex or religion. To satisfy the conditions of equity, fairness and justice, a management should take these factors into considerations.

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