

COURSE: REWARD MANAGEMENT

LECTURE 7: COMPONENTS OF COMPENSATION

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Lecture learning outcomes:

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

- i. Discuss the components of compensation

COMPONENTS OF COMPENSATION

Compensation management has become one of the issues both for employees and employers around the world due to its importance. 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 organizations.

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. Remuneration is another term synonymously used with the compensation.

Compensation Management

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 is 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. 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 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.

Components of Compensation

1. Basic Wages/Salaries

Basic wages / salaries refer to the cash component of the wage structure based on which other elements of compensation may be structured. It is normally a fixed amount which is subject to changes based on annual increments or subject to periodical pay hikes. Wages represent hourly rates of pay, and salary refers to the monthly rate of pay, irrespective of the number of hours put in by the employee. Wages and salaries are subject to the annual increments. They differ from employee to employee, and depend upon the nature of job, seniority, and merit.

2. Dearness Allowance

The payment of dearness allowance facilitates employees and workers to face the price increase or inflation of prices of goods and services consumed by him. The onslaught of price increase has a major bearing on the living conditions of the labour. The increasing prices reduce the compensation to nothing and the money's worth is coming down based on the level of inflation. The payment of dearness allowance, which may be a fixed percentage on the basic wage, enables the employees to face the increasing prices.

3. Incentives

Incentives are paid in addition to wages and salaries and are also called 'payments by results'. Incentives depend upon productivity, sales, profit, or cost reduction efforts. There are: (a) Individual incentive schemes, and (b) Group incentive programmes. Individual

incentives are applicable to specific employee performance. Where a given task demands group efforts for completion, incentives are paid to the group as a whole. The amount is later divided among group members on an equitable basis.

4. Bonus

The bonus can be paid in different ways. It can be fixed percentage on the basic wage paid annually or in proportion to the profitability. The Government also prescribes a minimum statutory bonus for all employees and workers. There is also a bonus plan which compensates the managers and employees based on the sales revenue or profit margin achieved. Bonus plans can also be based on piece wages but depends upon the productivity of labour.

5. Non-Monetary Benefits

These benefits give psychological satisfaction to employees even when financial benefit is not available. Such benefits are:

- (a) Recognition of merit through certificate, etc
- (b) Offering challenging job responsibilities
- (c) Promoting growth prospects
- (d) Comfortable working conditions

6. Commissions

Commission to managers and employees may be based on the sales revenue or profits of the company. It is always a fixed percentage on the target achieved. For taxation purposes, commission is again a taxable component of compensation.

7. Mixed Plan

Companies may also pay employees and others a combination of pay as well as commissions. This plan is called combination or mixed plan. Apart from the salaries paid, the employees may be eligible for a fixed percentage of commission upon achievement of fixed target of sales or profits or Performance objectives.

8. Piece Rate Wages

Piece rate wages are prevalent in the manufacturing wages. The laborers are paid wages for each of the Quantity produced by them. The gross earnings of the labour would be equivalent to number of goods produced by them. Piece rate wages improves productivity and is an absolute measurement of productivity to wage structure. The fairness of compensation is totally based on the productivity and not by other qualitative factors.

9. Fringe Benefits

Fringe benefits may be defined as wide range of benefits and services that employees receive as an integral part of their total compensation package. They are based on critical job factors and performance. Fringe benefits are supplements to regular wages received by the workers at a cost of employers. They include benefits such as paid vacation, pension, health and insurance plans, etc. Such benefits are computable in terms of money and the amount of benefit is generally not predetermined. The purpose of fringe benefits is to retain efficient and capable people in the organization over a long period.

10. Profit Sharing

Profit-sharing is regarded as a stepping stone to industrial democracy. Profit-sharing is an agreement by which employees receive a share, fixed in advance of the profits. Profit sharing usually involves the determination of an organization's profit at the end of the fiscal year and the distribution of a percentage of the profits to the workers qualified to share in the earnings.

11. 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.

12. Job Analysis

The process of analyzing jobs from which job descriptions are developed. Job analysis techniques include the use of interviews, questionnaires, and observation.

13. Job Evaluation

A system for comparing jobs for the purpose of determining appropriate compensation levels for individual jobs or job elements. There are four main techniques: Ranking, Classification, Factor Comparison, and Point Method.

14. 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.

15. Salary Surveys

Collections of salary and market data. May include average salaries, inflation indicators, 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. Know which industry or geographic location the salary results pertain to before comparing the results to your company.

16. Policies and Regulations

Compensation is supposed to be as fair if it is contained the system of components to develop and maintain internal and external equity in organization.

17. Compensation Plans –There are 12 steps to develop 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, as necessary, to determine their specific job functions.
- (iv) Decide which job classifications should be exempt and which should be non-exempt. (v) Develop model job descriptions for exempted and nonexempt 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, handouts, 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

Methods of Compensation

The operating companies need to develop a compensation package for their employees depending on the size and type of business, employers may choose to compensate their employees in a number of different ways. Below is given the different methods of compensation:

1. Wages and Salaries

Although we use the terms wages and salaries interchangeably, in payroll accounting, the two terms have different definitions. Wages refers to the earnings of employees whose pay is calculated on an hourly basis. Salary refers to the earnings of employees whose pay is calculated on a weekly, bi-weekly, semi-monthly, or monthly basis.

2. Commissions Sales

Commission plans vary greatly from company to company, but are generally based on the dollar amount of sales made during a payroll period. Commission income is considered the same as wages or salaries for withholding and reporting purposes. Commissions are usually computed on a certain percentage or commission rate. Some commissioned employees may not be exempt from the minimum wage requirement. The employer must determine the regular, hourly rate for each non-exempt salesperson during the week and make sure this rate is at least equal to the current minimum wage.

3. Piece-Rate Plan

Workers paid on a piece-rate plan receive a certain amount for each item produced. Gross earnings equal the rate per item multiplied by the number of items produced during the payroll period.

4. Combination Plan

Many businesses pay sales people both a salary and a commission. Such a combination plan provides some regular income and offers an incentive for superior sales.

5. Draws

Draws are often given to salespeople who work only for commission. A draw is an advance given to a salesperson that will be collected when future sales transactions are closed. Draws will be subtracted from a salesperson's.

6. Sick Pay

Sick pay is any amount paid to an employee because of illness or injury under a plan providing for such benefits. The amounts are disbursed by the insurance company or the employee's trust and are referenced as third party payments.

7. Tips

In certain businesses, employees receive compensation in the form of gratuities or tips. A tip is an additional amount from a customer for services rendered. Bartenders and restaurant servers usually receive tips in addition to wages. Hair stylists and taxi drivers also depend on tips as a major source of income.

8. Supplemental Wages

Supplemental wages differ from regular wages only in that they may be based on a different payroll period, computed on a different compensation plan or rate, or paid at a different time than regular wages. In addition, certain payments are, by their nature or timing, supplemental wages. Such payments include retroactive pay increases, severance pay,

bonuses, commissions, taxable fringe benefits, awards and vacation pay on termination. The distinction between regular and supplemental wages is important because special rules apply to withholding on supplemental wages.

9. Exempt Payments

Compensation not considered wages includes sickness and injury payments under a workers' compensation law, and other payments that are likely to be tax deductible such as qualified moving expense reimbursements.

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