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Certified Compensation and Benefits Manager

Sample Material

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V-Skills

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1. INTRODUCTION

Compensation is an integral part of the employer-employee relationship. All organizations today depend on human capital to execute on the organizational objectives and a good compensation management system plays an important role in motivating the performance of this human capital towards success.

What, then, is Compensation? Compensation can be defined as the remuneration (including monetary payments, such as salary/wages, allowances, fringe benefits, incentives and bonuses) received by an employee in return for their contribution to the organization. Compensation Management, in turn, consists of managing the entire process of compensating employees from creating well-designed compensation strategies to executing on these strategies in a manner that is consistent with the best interests of the organization while also being fair and equitable for all employees.

Salaries or wages paid to employees form the largest portion of expenses for any organization and so it becomes extremely important to formulate thoughtful and relevant strategies around compensation and its administration.

1.1 Objectives of Compensation Management

Compensation serves to not only motivate and retain employees who are already part of the organization, but also helps to attract good employees to the organization. A good Compensation Management System should be developed in line with strategic goals and business objectives, and fulfill the following functions

- ✓ It should be easily understood by employees and equitable across the organization
- ✓ It should not only play an integral part in motivating employees, but also aim to create a healthy competition among them
- ✓ It should balance internal as well as external equity, thus enabling employee retention and conversely reducing employee attrition
- ✓ It should help companies to achieve a competitive edge in the industry, thus attracting new talent
- ✓ It should be designed to reward employees in alignment with their performance levels, i.e. the better the performance, the higher the reward

- ✓ It should be clearly linked with other human resource activities within the organization such as recruiting, learning, performance management and so on.

To create robust compensation systems and organization must be aware of the following factors

- ✓ External factors such as laws, government regulations and market data for salaries
- ✓ Internal factors such as complete employee information, job analyses, job descriptions and job evaluations

1.2 Principles of Compensation Formulation

Designing compensation packages takes into account several other factors in addition to ones mentioned above. External factors such as supply & demand of labor, technology, level of economic development and social influences, and internal factors such as business strategy, organizational culture and internal equity also influence an organization's compensation policy to a great extent. An effective and fair compensation package looks at all of these factors in order to fulfilling the strategic objective of delivering best-in-class talent at competitive prices to the organization.

Formulating a compensation policy takes the following factors into account

- ✓ **Labor laws:** A question the organization must ask before finalizing a compensation policy is whether elements of the compensation package that must be included under governing laws are included. Legal compliance forms the basic pillar upon which a good compensation strategy is built.
- ✓ **Internal organizational structure:** The way the organizational chart looks also plays an important role in formulating compensation policies for an organization. The number of unique jobs within the organization, the different levels (from executives to line staff) and the total number of staff required to meet the organization's business goals must be taken into account when creating compensation plans. For example, an organization that requires a large number of workers with a wide range of skills will necessarily have a different compensation strategy than an organization that requires a smaller staff and is more reliant on automation. An evaluation of the internal structure leads to the creation of job descriptions, which is the key to the creation of any compensation policy.
- ✓ **Line of business:** The industry of the organization has a direct link with the labor market that the organization operates in and consequently impacts its compensation strategy. For

example, a retail organization would pay its people in a vastly different manner than a software services firm.

- ✓ **Competitiveness with external markets:** The organization must decide where it stands in terms of external market rates. The three pay strategies with regard to market competitiveness are to pay below market, at market or above market. Any one or a combination of these strategies may apply to the entire organization depending on the structure of its workforce and/or labor market conditions. An organization may choose to pay below market especially if supply of labor is ample and a particular job does not require specialized skills or education. For example, a retail organization may decide to pay below market for all floor staff. An organization may also choose to pay above market, typically where supply of labor is scarce and the job is highly specialized. For example, a research lab may choose to pay significantly above market in order to attract and retain the best scientists. Many organizations will simply have more than one strategy incorporated into a compensation plan. This typically happens when different jobs within the same organization have different external and internal factors affecting them.
- ✓ **Administration or execution:** Whether compensation administration will be centralized or decentralized is an important question that must be answered before creating an organization's overall compensation plan. Thus, how a particular strategy will best be executed while aligning with the overarching business goals is very important. Most organizations naturally gravitate towards a combination of centralization and decentralization. Typically, benefits decision may remain centralized as they are applicable to the vast majority of the employees in the exact same manner whereas base salary and variable pay decisions, including bonuses, may be decentralized allowing business units to manage employee performance and productivity by using compensation decisions as motivators.

Devising a compensation strategy for the organization can reap many rewards for the organization, the foremost being increased employee commitment. An employee who clearly understands how rewards link to his/her job performance behaviors will be more motivated to act in a way that promotes the organization's goals.

1.3 Types of Wages

There are three main categories of wages

- ✓ **Minimum wage:** The lowest wage, determined by law or contract that an employer must pay an employee for a specified job. Minimum wages not only provide for the bare physical needs but also ensures some fulfillment of basic needs such as education, health and other things. Minimum wage levels are determined either by law (Minimum Wages Act, 1948) or may be the result of a wage settlement agreement between employee and employer. Minimum wage is generally the lowest hourly, daily or monthly remuneration that employers must legally pay to workers.
- ✓ **Fair Wage:** Fair wages are somewhat above Minimum wage rates and aim to provide a "fair" wage for work done. Fair wages take the form of adjustable steps that move up according to the capacity of the industry to pay, and the prevailing rates of wages in the area of industry. Fair wages fall between the Minimum Wage and a Living Wage, and are related to productivity. Fair Wages also advocate the "equal pay for equal work" philosophy, which says that work of equal skills, or difficulty levels should receive equal or fair wages.
- ✓ **Living Wage:** Living wages can be defined as the wages that meet the normal needs of an average employee in the course of everyday life. Living wages should ideally enable the worker to meet basic needs (for an extended period of time or for a lifetime). These needs include shelter (housing) and other incidentals such as clothing and nutrition. The Living wage theory says that wages should not only be fair, but also be sufficiently high to provide comfort and insurance against important misfortunes.

1.4 Wage Policies

Across the globe, the Government has always had an interest in and a great influence on the employer-employee relationship, particularly as it related to the issue of compensation. This has taken the form of wage policies and regulations focusing on minimum wage, mandatory benefits and other aspects of compensation. In India, wage policies aim to create a structure around the national wage and salary system. The objectives of Government-regulated wage policies are

- ✓ Promote economic growth, employment, productivity, capital formation and price stability
- ✓ Remove wage differentials between different industrial sectors

- ✓ Set a minimum wage to ensure that workers in any industry or sector are able to purchase the basic necessities of life

Government-set policies form the basic guidelines for organizations in determining a wage structure. Typically, organizations divide compensation into the following components in line with prevailing wage policies

- ✓ **Basic wage or salary:** This is the base pay that is agreed upon for work performed and does not include any other components of compensation
- ✓ **Allowances:** These are payments above the amount of the base wage or salary. Dearness Allowances (DA), which were introduced to protect workers against the effects of inflation, are included in this category as are other types of allowances
- ✓ **Bonuses or Incentive Pay:** Bonuses or other forms of incentive pay are over and above any base wages and allowances. They are usually paid as a lump sum at one time during the business year or may be paid at regular pre-decided intervals (e.g. incentives for quarterly sales) and their primary purpose is to improve performance.
- ✓ **Benefits and other perks:** Groups insurance (e.g. Life Insurance or Medical Insurance), Provident Funds, reduced rates for loans, paid vacation and holidays, subsidized food and so on are all categories of fringe benefits or perks that employees sometimes receive from the employer as a part of the employment relationship.

Over the years, several pay commissions have been set up to debate the questions surrounding minimum wage, and minimum wage will continue to be reviewed and revised.

1.5 Procedure and Practices for Wage Determination

Setting wage rates is a key process in any compensation management system. Organizations need to understand how much they will need to pay their employees, as this expense is typically the largest portion of business expenses. How then is wage determined?

The Market Theory of Wage Determination assumes that wages are determined by supply and demand. All other considerations such as skill level of labor or location of open jobs are secondary to the basic equation of available labor versus demand for that labor in the market. Market Theory argues that wages will eventually be agreed upon by employers and employees based on all of the above factors. In addition, any change in labor or demand will affect wages proportionately, i.e. scarcity of labor will increase wages and vice versa.

However, this theory ignores the fact that in real market conditions there may be a gross imbalance of bargaining power between employers and employees leading to wage rates that do not meet even subsistence standards for workers. This is where wage policy becomes important.

In the Indian context, the Minimum Wages Act, 1948 was passed to lay down norms and procedures for fixing wages by government. A tripartite committee on fair wages was setup in 1949 to determine principles for promotion of wages, and wage Policy was introduced in the First Five Year Plan to ensure full employment & optimum allocation of resources.

In India, wages and salaries are determined through several different procedures

- ✓ **Collective Bargaining:** The negotiation between organized workers and their employer or employers to determine wages, hours, rules, and working conditions constitutes Collective Bargaining. Trade Unions influence the general level and structure of wages under collective bargaining. Workers have the right and capacity to strike, thus promoting democracy. Several laws influence Collective Bargaining efforts. Some of these are the Factories Act, 1948, Industrial Disputes Act, 1947 etc.
- ✓ **Industrial Wage Boards:** Industrial Wage Boards consist of an equal representation of employers and employees as well as an independent Chairman. India has a statutory wage board and a Tripartite wage board. Wage Boards were set up so that industrial disputes could be referred to them without the need to move a Court of Law. The decisions of a Wage Board are binding on the parties.
- ✓ **Pay Commissions:** The Pay Commission is an administrative system / mechanism that the government of India set up in 1956 to determine the salaries of government employees. It was proposed that in no circumstance could the wage of any worker be less than the Living Wage. Since then, there have been 6 Pay Commissions.
- ✓ **Adjudication:** Courts and Tribunals intend to deal with settlement of industrial disputes concerning wages and salaries.

1.6 Compensation Decisions

Compensation management is a strategic business decision and one of its most important functions is to link individual performance with pay. The other important function of compensation management is to align the compensation strategy with the overall goals of the business in such a way as to strike the perfect balance between costs of human capital and its productivity. Compensation strategy thus becomes a powerful tool for reinforcing the existing business model.

A basic compensation management program aims at attracting and retaining talent to ensure cost minimization and profit maximization. An effective compensation program intends to improve productivity, and create a mindset of ownership among the workers, for the given job. Compensation decisions help nurture a performance-oriented culture as they focus on giving effective feedback for greater accountability.

Compensation decisions will be considered fair only if they are communicated effectively, at the right time and through appropriate channels to all employees. Employees read between the lines. Hence, they infer things such as their position in the organization, company's ability to pay, company's attitude towards fair pay and such.

Compensation decisions also have an effect on the culture and climate of the organization. At some level, the organization needs to be transparent to a certain extent about how they are determining compensation, particularly at the managerial level. It is beneficial to communicate whether the increase in compensation is due to market correction measures, or to acknowledge exceptional performance, or increase in the cost-of-living.

Organizations need to have a have a clear idea of the overall compensation strategy they wish to follow in order to make better real-time decisions about pay structures for groups of employees. The most enduring framework for understanding a compensation management system comes from Milkovich and Newman (2005) and lists four clearly defined areas for consideration when taking any compensation decision. These are

- ✓ **Alignment:** The comparison of jobs and skills within one single organization is called internal alignment. This is a crucial aspect of compensation decision-making since the important of a particular job within a business is almost always tied to its relative worth to the business. For example, a business would want to compare the work and requisite skills of a customer service operator who is the first point of contact for all its customers to the work and requisite skills of a technical resource who may never meet a customer, but who plays a key role in creating the product the business sells. Internal alignment impacts not only pay for jobs across the organization but can also be used to adjust pay rates within a particular job to differentiate performance.

- ✓ **Competitiveness:** External competitiveness of the business in the labor market is another key aspect of compensation decision-making. An organization must first decide where on the market scale they will pay - below market rate, below market rate or above market rate - in order to attract and retain the kind of talent they need. In each scenario, there are inherent advantages and disadvantages. For example, and organization that pays above market will not have as much trouble attracting talent as its counterparts because the pay scales are higher than their competitors in the market. On the flip side, the cost of doing business also increases with the increase in salary budgets. Paying above market may also distort the labor market conditions eventually by pushing wages up in an effort to remain above market. Maintaining external competitiveness is thus a fine balance between controlling internal labor costs while remaining attractive as an employer in the labor market.
- ✓ **Contributors:** How pay structures should be designed and based on what criteria from the point of view of employee contributions is another key aspect of compensation design. Organizations may choose to have seniority-based systems of pay differentiation and pay increases where longevity within the organization gets rewarded. Or, organizations may choose to reward performance, based purely on merit. Differentiations between pay strategies for management employees versus other rank-and-file employees also come into play here and include incentive pay and fringe benefits.
- ✓ **Administration:** Finally, the execution of the compensation strategy is the fourth piece of the compensation decision-making model. How the compensation management system id administered will often determine the success or failure of strategy decisions. Has adequate planning gone into creating pay structures for different roles and levels of employees? Have the pay structures been clearly communicated to all employees in the organization? Do the pay structures further the goals of the organization in terms on internal alignment, external competitiveness and employee contributions?

1.7 Compensation Benchmarking

Benchmarking means a measurement of the quality of an organization's policies, products, programs, strategies, etc., and their comparison with standard measurements, or similar measurements of its peers.

Compensation Benchmarking is a key precondition in designing a pay package. For attracting top talent, it is imperative to perform a salary market study, in spite of the fact that it can be time-consuming and costly. An organization must be well informed on what the market is paying for certain skill sets.

Compensation Benchmarking not only aids the recruitment function, but also provides an opportunity for reviewing the compensation policies within the organization vis-à-vis market practice. Factors such as industry, job location, job function, skill sets and its relative demand, corporate philosophy, size of the organization, working condition and so on could serve as a basis of comparison.

Salary surveys are conducted by consulting firms, industry associations, or educational forums on a semi-annual, annual, or biennial basis. There can be two broad types of surveys, namely – Custom surveys and Standard surveys. At a basic level, salary-benchmarking methods compare remuneration packages of similar companies in a particular industry. At an in-depth level, it also studies the business strategies.

Companies participating in such surveys are required to share their job descriptions, compensation structure, incentive plans, bonus schemes, and business philosophies. Hence, companies are generally hesitant to give accurate and complete data for the purpose. Also, such survey data becomes outdated very soon as it is time-sensitive. Choosing and using an accurate data source is thus vital.

1.8 Compensation Trends and Practices in India

Key regulations such as the Workmen’s Compensation Act, Minimum Wages Act, Industrial Disputes Act, Payment of Wages Act, Payment of Bonus Act and Payment of Gratuity Act in addition to a few others govern the basic design and execution of many components of and organization’s compensation structure.

Prior to 1991, the Government of India was the biggest employer, and thus pay structures were largely influenced by trade unions. The private sector also used government pay structures as the benchmark for their compensation programs. Salary progression was largely determined by length of service, variable pay was largely restricted to top management officials.

In 1991, with reforms like liberalization, privatization and globalization the markets were deregulated, and private sector started gaining more market share. India transitioned to a market-driven economy. There was a significant increase in productivity & faster growth in real wages. With outsourcing of IT and ITES (IT enabled services), simplification of tax rules and a booming competitive economy led to a substantial increase in the GDP growth rates. Flexible benefits, variable pay, perquisites and allowances, linking of pay to performance characterized compensation components. Cost to Company (CTC) concept was introduced.

With outsourcing, and a boom in the IT, Healthcare and Services sectors, the disposable incomes in the hands of an individual have increased. The ever-increasing competition no longer considers length of service in a particular organization as a deciding factor for salary increments. The role of trade unions now remains restricted to the public sector only. Bonuses have been replaced by incentives & rewards for achieving defined goals and objectives. Competency-based compensation programs, Broad-banding, performance incentive, stock options are some of the features of innovative compensation programs today.

Self-Assessment Questions

1. Which one of the following is NOT an objective of an effective Compensation System?

A. Employee motivation
B. Employee retention
C. Employee attrition
D. Employee satisfaction

2. Which one of the following is the correct ascending order of wages?

A. Minimum wages, Fair wages, Living wages
B. Living wages, Minimum wages, Fair wages
A. Fair wages, Minimum wages, Living wages
B. None of the above

3. Which one of the following is NOT a standard process for wage fixing in private industry in India?

A. Collective bargaining
B. Industry wage boards
C. Pay commissions
D. Adjudication

4. Which one of the following serves as a tool for benchmarking the compensation strategy?

A. Industry survey
B. Employee evaluation
C. Job analysis
D. Company mission

5. Which one of the following is NOT a consideration for a well-defined compensation system?

A. Incentives
B. Internal Alignment
C. External Competitiveness
D. Administration

Answer: 1 – C, 2 – A, 3 – C, 4 – A, 5 – A