COMPENSATION MANAGEMENT UNIT 1

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INTRODUCTION TO COMPENSATION MANAGEMENT

- Compensation refers to all forms of financial and non-financial returns provided to employees
  - It is a core function of Human Resource Management
  - Acts as a tool to attract, motivate, and retain talent
  - Links employee performance with organizational goals
  - Critical for achieving competitive advantage

- In modern organizations, compensation management is no longer limited to paying wages or salaries. It is a **strategic HR function** that integrates employee rewards with organizational objectives. According to **Richard I. Henderson**, compensation includes *all financial returns, tangible services, and benefits employees receive as part of an employment relationship*.
- In a **knowledge-based economy**, where intellectual capital, innovation, and skills drive competitive advantage, compensation systems must attract, motivate, and retain highly skilled employees while supporting organizational strategy.
- Compensation management today focuses on:
- Strategic alignment with business goals
- Fairness and equity
- Motivation and performance
- Legal and ethical compliance

- Compensation is referred to as money and other benefits received by an employee for providing services to his employer.
- Compensation refers to all forms of financial returns, tangible services, and benefits employees receive as part of an employment relationship, which may be associated with the employee’s service to the employer like provident fund, gratuity, insurance scheme, and any other payment which the employee receives or benefits he enjoys instead of such payment.
- Compensation is the human resource management function that deals with every reward individuals receive for performing an organizational task.
- Compensation management, also known as wage and salary administration, remuneration management, or reward management, is concerned with designing and implementing a total compensation package.

MEANING AND DEFINITION OF COMPENSATION

- According to Dale Yoder, "Compensation is paying people for work."
- Compensation is what employees receive in exchange for their contribution to the
- organization." – Keith Davis.
- In the words of Edwin B. Flippo, "The function compensation is defined as
- adequate and equitable remuneration of personnel for their contributions to the organizational
- objectives."
- Cascio has defined compensation as follows;
- "Compensation includes direct cash payments, indirect payments in the form of
- employee benefits, and incentives to motivate employees to strive for higher levels of
- productivity."
- Beach has defined wage and salary administration as follows;
- "Wage and salary administration refers to establishing and implementing sound
- policies and practices of employee compensation.

3-P CONCEPT IN COMPENSATION MANAGEMENT

- **Pay for Position Pay for Person**
- **Pay for Performance**
- **Pay For Position**
- 1. **Pay for position,** Position based pay or Job-based pay, pays employees for the job to which they are assigned, regardless of the skills they possess.
- In other words, pay is centered on the job or position and not on the person. Pay for Position is a more traditional pay structure in which each position is assigned a pay range based on the job duties and pay is based on education and seniority.
- Employee compensation is set in broadband based on qualifications, education, training & experience
- Through broad banding, narrowly structured pay grades determined through job evaluation, arereplaced by fewer and wider bands
- Employees progress up through broad band if their performance ratings are good, rather than throughsteps based on time in the grade
- It reduces different compensation categories to broad compensation bands. Grouping jobs together bycommon characteristics.
- Develop an equitable grading structure Create a reference salary structure
- Leverage compensation costs with market survey information

PAY FOR PERSON

- Pay for Person or Person focused pay or Skill-based pay or Knowledge-based pay or Competency-based pay structures link pay to the depth or breadth of the skills abilities competency and knowledge a person acquires and applies to the work.
- Structures based on skill, pay individuals for all the skills ofr which they have been certified regardless of whether the work they are doing requires all or just a few of those particular skills
- The wage is attached to the person.
- The pay increases are usually tied to three types of skills:
- Horizontal skills, which involve a broadening of skills in terms of the range of tasks
- Vertical skills, which involve acquiring skills of a higher level
- Depth skills, which involve a high level of skills in specialized areas relating to the same job.
- Because skill-based pay encourages and rewards a broad range of skills, the employee becomes multi-skilled and more flexible and valuable; A job rotation is used to fill in temporary gaps in the workforce.
- Pay for person takes into account the demonstrable characteristics of a person, including knowledge, skills, competency and behaviors, that enable performance Take into consideration the person's capabilities & experience in setting a pay level that is both equitable and competitive
- It considers the market demand of a person's unique skills and experience It also incorporates market based pay approach.

PAY FOR PERFORMANCE

- Pay for Performance, Performance related pay, Performance-based pay is a financial reward system for employees where some or all of their monetary compensation is related tohow their performance is assessed relative to stated criteria.
- The criteria for performance-related pay scheme may be based on individual, group or
- organizational performance, or on a mixture of them.
- Individual-based criteria would require-
- individual goal-setting,
- an appropriate performance appraisal system
- individual training to increase job knowledge & skills and
- the individual should have a large measure of control over his/her own performance.
- Team-based criteria are appropriate where individual performance is difficult to measure,
- or where there is a need for a corporate culture to promote team values and cooperation.

SALARY

- A salary is a periodic payment form an employer to an employee, which may be specified in an employment contract
- While there was no first pay stub for the first work for pay exchange, the first work would have required a human society advanced enough to have a barter system to allow work to be exchanged for goods or other work. A fixed payment at regular intervals for services, esp. when clerical or professional
- In many countries, salaries are based not on the number of hours worked, but on general job performance.
- A salary is an agreed upon amount of pay that is to be extended at regular intervals, in exchange for the competent performance of specific tasks within the workplace.
- Salary is a fixed amount of money or compensation paid to an employee by an employer in return for work performed.

WAGES

- The wage is a compensation, usually financial, received by workers in exchange for their labor.
- Monetary remuneration computed on hourly, daily, weekly, or piece work basis.
- The share of the products of industry received by labor for its work
- The share of the national product attributable to labor as a factor in production.

EMPLOYEE INCENTIVE

- □ Informal word for perquisites which are privileges granted to employees in addition to
- their salaries and benefits (such as medical and pension plans).
- □ 'True' perks have little or no cash value or tax implications and may include company car,
- vacations, reserved parking space, spacious office, private dining and washroom
- facilities, etc.

ALLOWANCE

- An allowance is a amount of money set aside for a designated purpose.
- Parents giving some amount of money (pocket money) to the children is also known as
- allowance.
- Money given to employees who have to relocate due to their work.
- The allowance is used to pay for expenses related to moving of residence such as
- transportation, storage costs, temporary lodging and meals.
- The allowance may be given in lump- sum or reimbursed upon submission of receipts

PERKS

- Perks in simple word is also known as ‘Employee benefits’ or ‘Benefits in kind’.
- It is non wage compensation provided to the employees in addition to their normal salaries or wages.

- **Intrinsic Compensation**
- - Employees' critical psychological state that results from performing their jobs
- - Enhanced when jobs are rated high on five core job dimensions:
- skill variety – requires a person to perform different tasks and involves different skills,
- abilities and talents
- task identity - complete a job from start to finish
- task significance – when the job has an impact on the lives of other people
- autonomy – freedom, discretion the employee has in determining how to perform the job
- Feedback – providing employee with clear information about job outcomes and
- Performance

- **Extrinsic Compensation**
- Monetary rewards: Given to employees according to their performance levels or learning
- job related knowledge an skills. This is core compensation. It includes base pay; cost of living adjustment; seniority pay; merit pay; incentive pay; knowledge/skill based pay etc/.
- Non-monetary rewards: Includes protection programs (medical insurance); paid time-off
- (vacations); services (day care). This is fringe compensation or employee benefits. This includes legally required benefits; discretionary benefits etc.

Core Dimensions: Intrinsic vs. Extrinsic

Foundational compensation strategies categorize rewards into two primary dimensions:

• **Intrinsic Compensation:** This involves an employee's **psychological state** resulting from their job, enhanced by core dimensions such as skill variety, task identity, task significance, autonomy, and feedback.

• **Extrinsic Compensation:** This includes **monetary rewards** (core compensation like base pay, merit pay, and incentives) and **non-monetary rewards** (fringe benefits like medical insurance, paid time-off, and childcare services)

COMPENSATION AS AN HRM FUNCTION

- Ensures fair remuneration for work performed
  - Supports recruitment and selection effectiveness
  - Influences employee satisfaction and morale
  - Helps in controlling labor costs
  - Plays a role in industrial relations

OBJECTIVES OF COMPENSATION MANAGEMENT

- To attract qualified and competent employees
  - To retain talented workforce
  - To motivate employees for higher productivity
  - To ensure internal and external equity
  - To comply with legal requirements

OBJECTIVES OF COMPENSATION MANAGEMENT

- The various are as follows:
- 1**. Compensation consistency**
- There should be internal and external consistency in compensation.
- Internal compensation involves a payment based on the job role of the employees.
- External compensation means higher compensation and benefits is related to the best performing employees.
- 2**. Additional administrative efficiency**
- All the salaries and wages need to be managed effectively, making sure that there is the optimal use of HRIS.
- 3. **Adherence to all the laws**
- A well-balanced salary and wage structure take into consideration all the legal compliances of the organization.
- They make sure that the employers adhere to all the legalities involved in handing out the compensation.

OBJECTIVES OF COMPENSATION MANAGEMENT

- **Attracting Qualified Employees**
- One of the most important objectives of compensation is to attract competent and skilled employees from the labor market. A competitive pay structure enables organizations to draw high-quality applicants and build a strong talent pool, especially in knowledge-intensive industries.
- **Retention of Employees**
- Compensation helps in retaining experienced and high-performing employees. When employees perceive their pay as fair and competitive, they are less likely to leave the organization. An effective compensation system reduces employee turnover and associated recruitment and training costs.
- **Motivating Employees for Higher Performance**
- Compensation acts as a strong motivational tool. Performance-linked pay such as incentives, bonuses, and merit pay encourages employees to improve productivity and efficiency. Pay-for-performance systems help align individual efforts with organizational objectives.

OBJECTIVES OF COMPENSATION MANAGEMENT

- **Promoting Organizational Efficiency**
- Well-designed compensation systems improve overall organizational efficiency by encouraging productive behavior, reducing absenteeism, and increasing employee engagement. Compensation supports goal achievement by reinforcing desired behaviors.
- **9. Supporting Career Growth and Skill Development**
- Modern compensation systems reward skill acquisition and professional development. Skill-based and competency-based pay motivate employees to upgrade their knowledge, which is crucial in a knowledge-based economy.
- **10. Enhancing Employee Satisfaction and Morale**
- Fair and transparent compensation improves employee satisfaction, morale, and commitment. Satisfied employees show higher loyalty and contribute positively to organizational culture and long-term success.

IMPORTANCE OF COMPENSATION MANAGEMENT

- It integrates employees' efforts towards *organizational goals*.
- It helps in acquiring, maintaining, and creating a *motivated workforce*.
- Compensation is an essential *tool* for managers in human resource management.
- Helpful in attracting a talented workforce and creating *organizational brand value*.
- It enables enhancement in work efficiency and job satisfaction among employees.
- Compensation management helps in the creation of *talent pools*.

PRINCIPLES OF COMPENSATION MANAGEMENT

- The company should pay compensation according to its **ability to pay**. If they spend more/less than their ability, they may suffer bankruptcy, or competitors may take advantage of it.
- Organizations must keep in mind **internal and external equity** while compensating.
- There should be a **performance-based** rewarding system. It will result in maintaining fairness and justice in the organization.
- Remuneration paid to employees should be **non-discriminatory**. It must be irrespective of factors like religion, gender, etc.
- Organizations must pay **minimum wage** to distinct categories specified by law.
- The compensation scheme should be **flexible** and **simple**. It should be easy to understand and update according to requirement

FORMULATION OF COMPENSATION POLICY

- A compensation policy is a **systematic framework** that guides how an organization determines and administers employee pay. It ensures that compensation decisions are **consistent, fair, competitive, and aligned with organizational objectives**. According to **Milkovich and Newman**, compensation policy plays a strategic role in balancing employee expectations with organizational affordability and market realities.
- **Meaning of Compensation Policy**
- Compensation policy refers to the **principles and guidelines** adopted by an organization for determining employee remuneration, including wages, salaries, incentives, and benefits. It reflects management's philosophy regarding employee rewards and acts as a reference point for all pay-related decisions.

Need for Formulation of Compensation Policy

1. Strategic Alignment with Business Goals

A formal policy ensures that the compensation system is in **alignment with the company's overall strategy and mission**. By internally aligning business structures, an organization can redefine its mission to ensure all employees are moving in a "straight line" toward achieving end goals rather than working haphazardly.

2. Talent Attraction and Retention

In an increasingly competitive market, a well-thought-out policy acts as a **differentiating factor** that helps a company attract top-profile applicants and retain existing talent. It protects the company's **Return on Investment (ROI)** in the hiring and training process by reducing high turnover rates, which are often caused by compensation that is not up to industry standards.

3. Maintenance of Internal and External Equity

The formulation of a policy is necessary to guarantee a **system of fair pay for everyone**.

- **Internal Equity:** Ensures that positions with similar responsibilities or values are paid comparably.
- **External Equity:** Ensures the company pays in relation to the **external market**, maintaining a competitive position through benchmarking and salary surveys.

NEED FOR FORMULATION OF COMPENSATION POLICY

4. Cost Efficiency and Budgetary Control
A constructed compensation plan helps an organization **control costs**. By designing a policy in line with the company's financial situation and salary budget, the organization can ensure its pay practices are viable and avoid future budgetary shortfalls. Strategic policies help businesses **save money** while simultaneously boosting overall performance.

5. Legal Adherence and Risk Mitigation
Organizations must adhere to various **central and national salary legislations**. A formal policy ensures the company remains on the "right side" of labor laws, such as the Minimum Wages Act or the Equal Remuneration Act, thereby mitigating compliance and legal risks.

6. Behavioral Inducement and Motivation
A key need for policy formulation is to **cultivate a good work ethic and attitude**. When the payment structure is designed to reward specific accomplishments, it serves as a powerful motivator for higher productivity and induces desired behaviors among the workforce

STEPS IN THE FORMULATION OF COMPENSATION POLICY

- **1. Analysis of Organizational Objectives and Strategy**
- The first step involves understanding the organization’s:
- Business goals (growth, stability, innovation, cost leadership)
- Competitive strategy
- Long-term vision
- Compensation policies must align with business strategy. For example, innovation-driven firms may emphasize performance-based and skill-based pay.

STEPS IN THE FORMULATION OF COMPENSATION POLICY

- **2. Job Analysis and Job Evaluation**
- Job analysis provides detailed information about job duties, responsibilities, and required competencies.
  Job evaluation determines the **relative worth of jobs** within the organization.
  This step ensures **internal equity** by establishing a logical job hierarchy.
- **3. Analysis of Labor Market Conditions**
- Management studies:
- Prevailing wage rates
- Demand and supply of skills
- Industry pay standards
- Market analysis helps organizations remain competitive and avoid wage distortions.

STEPS IN THE FORMULATION OF COMPENSATION POLICY

- **4. Compensation Benchmarking and Salary Surveys**
- Salary surveys are conducted to compare the organization’s pay levels with those of competitors.
  Benchmarking helps decide whether the organization will:
- Lead the market
- Match the market
- Lag the market
- This step ensures **external equity**.
- **5. Determination of Pay Structure**
- Based on job evaluation and market data, management designs:
- Pay grades or pay bands
- Minimum, midpoint, and maximum salary levels
- Fixed and variable pay components
- This structure ensures consistency in compensation administration.

STEPS IN THE FORMULATION OF COMPENSATION POLICY

- **6. Deciding Pay Mix**
- Pay mix refers to the proportion of:
- Basic pay
- Variable pay
- Benefits and perks
- A higher variable pay is common in sales and performance-driven roles, while stable roles have higher fixed pay.

- **7. Consideration of Legal and Statutory Requirements**
- Compensation policy must comply with labor laws such as:
- Minimum Wages Act
- Payment of Bonus Act
- Employees' Provident Fund Act
- Equal Remuneration Act
- Legal compliance protects the organization from penalties and disputes.

STEPS IN FORMULATION OF COMPENSATION POLICY

- **8. Approval by Top Management**
- The proposed compensation policy is reviewed and approved by top management to ensure:
- Financial feasibility
- Strategic alignment
- Organizational consistency

- **9. Communication to Employees**
- Clear communication is essential for successful implementation. Employees should understand:
- Pay structure
- Incentive schemes
- Performance criteria
- Transparency builds trust and acceptance.

- **10. Implementation, Review, and Control**
- After implementation, the compensation policy must be:
- Periodically reviewed
- Adjusted for inflation and market changes
- Monitored for effectiveness
- Regular revisions ensure the policy remains relevant and competitive.

COMPENSATION AND NON-COMPENSATION DIMENSIONS

- Employee rewards in an organization consist of both **monetary (compensation)** and **non-monetary (non-compensation)** elements. In modern human resource management, especially in a **knowledge-based economy**, both dimensions are equally important in attracting, motivating, and retaining employees.

1. COMPENSATION (MONETARY DIMENSIONS)

- **1. Compensation (Monetary Dimensions)**
- Compensation refers to **financial rewards** paid to employees in return for their services. It directly satisfies employees' economic and security needs.
- **A. Direct Compensation**
- Direct compensation is paid in cash and forms the core of employee earnings.
- **Includes:**
- Basic wages or salary
- Dearness allowance
- Incentives and bonuses
- Commission
- Overtime pay
- **Importance:**
- Provides financial security
- Motivates performance
- Influences employee lifestyle and standard of living

INDIRECT COMPENSATION

- Indirect compensation consists of benefits and services provided in addition to direct pay.
- **Includes:**
- Provident fund
- Gratuity
- Insurance (health, life)
- Paid leave and holidays
- Retirement benefits
- **Importance:**
- Enhances long-term security
- Improves employee loyalty
- Supports work–life balance

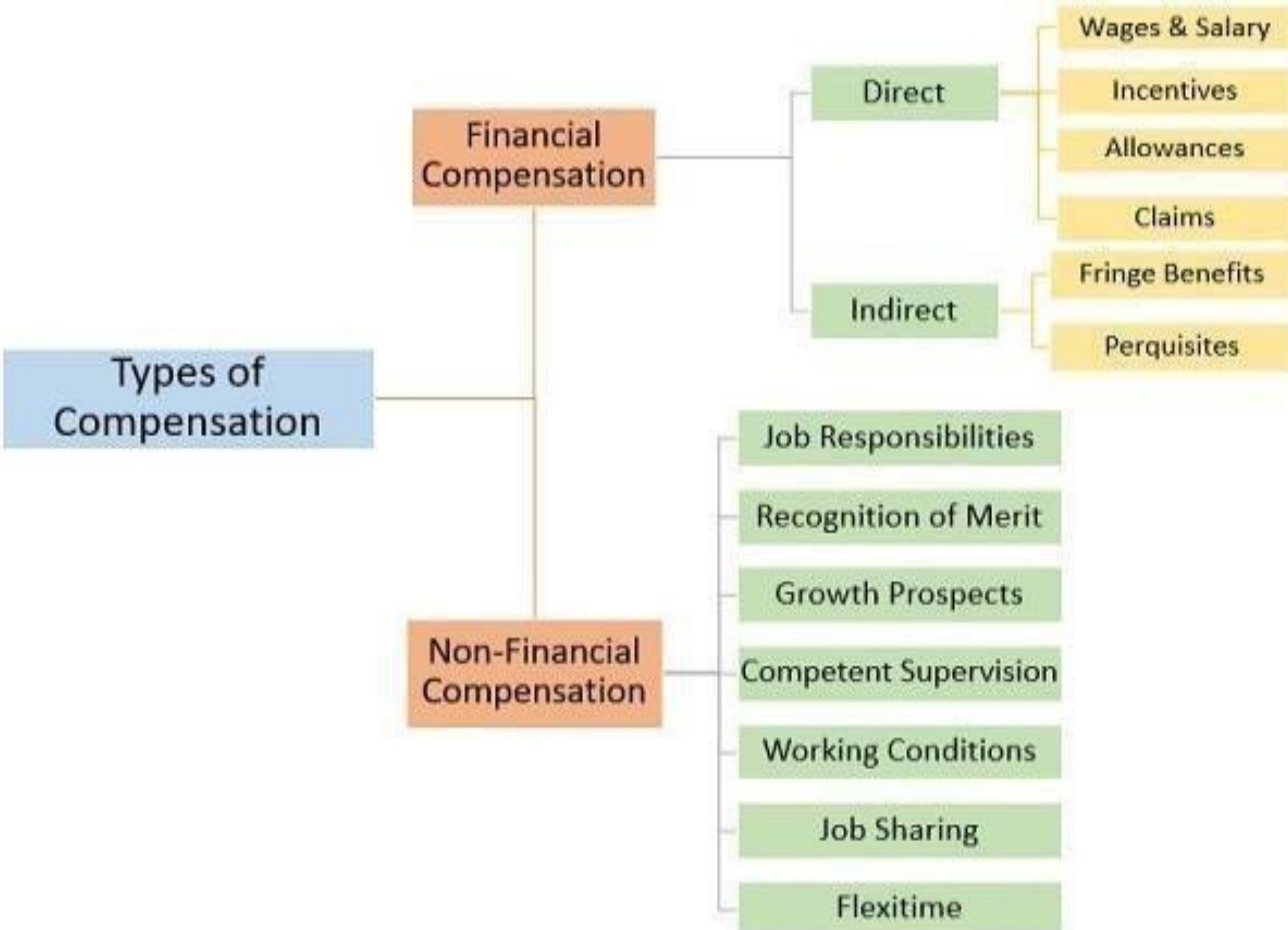
NON-COMPENSATION (NON-MONETARY DIMENSIONS)

- Non-compensation refers to **non-financial rewards** that satisfy employees' psychological, social, and self-esteem needs. According to **B. D. Singh**, non-monetary rewards play a critical role in motivating knowledge workers.
- **A. Career and Growth-Related Dimensions**
- Training and development opportunities
- Career advancement and promotions
- Skill development programs
- **Importance:**
- Encourages continuous learning
- Improves employability
- Enhances employee commitment

- **B. Work-Related Dimensions**
- Job autonomy
- Meaningful and challenging work
- Participation in decision-making
- **Importance:**
- Improves job satisfaction
- Encourages creativity and innovation
- Enhances sense of responsibility

- **C. Recognition and Status Dimensions**
- Appreciation and praise
- Awards and certificates
- Titles and status symbols
- **Importance:**
- Boosts morale and self-esteem
- Reinforces positive behavior
- Builds a performance-oriented culture

TYPES OF COMPENSATION MANAGEMENT



TYPES OF COMPENSATION MANAGEMENT

- Employers can make use of different components for compensating their employees. These components or types of compensation are as follows:
- Financial Compensation
- Non-Financial Compensation

1.Financial Compensation

In this form of compensation, the payment of rewards takes place in monetary terms. It is further divided into:

Direct Compensation Indirect Compensation

Direct Compensation

1. Wages and Salary

The compensation paid daily for intra-day work is known as Wages. Whereas, Salary is the monthly paymentfor the work performed.

2. Incentives

It is the money received in addition to wages or salary based on individual performance.

3. Allowances

Apart from a basic salary, the employer pays a certain amount for a specific purpose or expenditure. Differenttypes of allowances are part of compensation management like:

- Dearness Allowance
- House Rent Allowance
- Conveyance Allowance
- Leave Travel Allowance, etc.

Indirect Compensation

1. Fringe Benefits

These are the financial benefits received by the employees.
Fringe Benefits include: Provident Fund
Gratuity Medical Care Accident Relief Insurances, etc.

Perquisites

These are the benefits allowed to the executives above salary.
Perquisites include:
Company Car
Club Membership
Paid Holiday
Furnished House
Stock option scheme

2. Non-Financial Compensation

In this form of compensation, the employees receive
non-monetary rewards. Non-Financial compensation consists of:

Challenging Job Responsibilities Recognition of Merit
Growth Prospects Competent Supervision
Comfortable Working Conditions Job Sharing
Flextime, etc.

Compensation Decisions

Meaning

Compensation decisions refer to the strategic and operational choices made by management regarding **how much**, **how**, and **on what basis** employees are rewarded for their work.

These decisions directly affect:

- Employee motivation
- Attraction and retention of talent
- Organizational performance
- Cost control and competitiveness

Key Areas of Compensation Decisions

1. Pay Level Decision (How Much to Pay)

Determines the **overall salary level** of the organization compared to the market.

Influenced by:

 Industry standards

 Organizational financial capacity

 Skill scarcity

 Legal requirements

2. Pay Structure Decision (How to Pay)

- Involves designing:
  - Pay grades
  - Pay ranges
  - Salary bands
- Ensures **internal equity**.

3. Pay Mix Decision (What to Pay)

Ratio between:

Fixed pay (basic salary)
Variable pay (incentives, bonuses)
Benefits and perks

4. Performance-Based Pay Decision

Linking compensation with:

Individual performance
Team performance
Organizational results

COMPENSATION BENCHMARKING

- **Meaning**
- **Compensation benchmarking** is the process of **comparing an organization's compensation practices with those of competitors or industry standards** to ensure market competitiveness and fairness.

- **Advantages of Compensation Benchmarking**
- Ensures competitive pay
- Improves employee satisfaction
- Helps strategic workforce planning

TYPES OF BENCHMARKING

- **1. Market Benchmarking**
- Comparison with:
  - Industry competitors
  - Similar-sized organizations
- Uses salary surveys.
- **2. Competitive Benchmarking**
- Focuses on direct competitors for talent.
- **3. Internal Benchmarking**
- Comparison of pay levels across departments or locations within the organization.
- **4. Functional Benchmarking**
- Comparison of specific job roles (e.g., HR Manager, Software Engineer) across industries.

REWARD STRATEGIES – ARTICULATING AND UNDERSTANDING BUSINESS CONTEXT

- **Meaning of Reward Strategy**
- A **reward strategy** is a long-term plan that defines **how an organization rewards its employees** to support business objectives.
- It aligns:
- Compensation
- Benefits
- Recognition
- Career development
- with the **organizational strategy**.

KEY BUSINESS FACTORS INFLUENCING REWARD STRATEGY

- **1. Business Strategy**
- **Cost leadership** → Controlled pay, standardized rewards
- **Differentiation** → Higher pay for innovation and skills
- **Growth strategy** → Performance-linked incentives

2. Organizational Life Cycle

- **Start-up stage** – Lower fixed pay, equity-based rewards
- **Growth stage** – Incentives and skill-based pay
- **Maturity stage** – Structured pay, stability
- **Decline stage** – Cost containment

KEY BUSINESS FACTORS INFLUENCING REWARD STRATEGY

- **3. Industry and Market Conditions**
- High competition for talent → Aggressive rewards
- Stable industries → Conservative rewards
- **4. Workforce Characteristics**
- Knowledge workers → Skill-based and flexible rewards
- Blue-collar workforce → Job-based pay
- Multigenerational workforce → Customized benefits
- **5. Financial Capability**
- Profitability
- Cash flow
- Shareholder expectations