7. Remuneration and reward management

7.1 Reward management

The terms 'remuneration' and 'compensation' are commonly understood: it is the wages or salary paid to an employee for services provided to the employer. However, there are a number of competing definitions for 'reward management' or 'performance-related pay'. Each of these definitions hinges on relating some proportion of the remuneration of an individual, a group, unit or team of an organisation to the performance of that individual, group, unit or team. These are systems where some element of the organisation's remuneration system is based on the effort, output or overall performance of its workforce.

Essentially, the process seeks to strategically link the business's objectives with the performance management systems (PMSs) and employee remuneration and reward. The systems try to measure, manage and reward the key outcomes of an employee role, providing reward when an individual or team exceeds the performance objectives.

However, designing an effective reward system can be a complex process with a series of questions which should be considered by an organisation before embarking on the exercise. Some of these questions are:

- If the reward element of pay is a proportion of the employee total remuneration, what is the optimal proportion, and what are the current proportions?
- How do you ensure fairness and objectivity in the system?
- How do you measure performance? What is productivity?
- How are improvements measured?
- Is team or individual reward more effective?

7.2 Strategic remuneration and reward management

New ideologies, work attitudes and, most important of all, commitment to the organisation and group outcomes are essential elements to remaining competitive in today's business environment. Effective management of remuneration and reward systems is crucial to supporting the organisation to respond to these demands.

A key element of the design of a remuneration and reward system is an in-depth analysis of the motivation of individual employees, and strategic policies designed to harness these factors to maximise effort and productivity. Common to all effective systems is the understanding that traditional pay structures and methodologies do not support progressive managerial and operational structures and objectives, and are unable to maximise the necessary alignment of employee behaviours and organisational goals.

Despite increased responsibilities and changing corporate environments, many employees are still paid the same way they were 10 to 20 years ago. Organisations have adopted many of the new principles of management yet still pay annual merit increases, and determine pay levels on the basis of an employee's knowledge, length of service and number of direct reports. These measures are at best inconsistent, at worst entirely irrelevant to the design of the modern organisation.

Today's flatter, streamlined structures require an appropriately-designed remuneration and reward system that synchronises with the new era of management.

7.3 Establishing a pay structure

7.3.1 Job evaluation systems

Job evaluation forms the basis for establishing the organisation job hierarchy and associated salary structure. All systems evaluate jobs rather than employees and all require up-to-date, well-written job descriptions.

Organisations must complete some form of job evaluation to ensure their pay structure is defensible and equitable. Put simply, formal methods of evaluation are required to ensure accurate measurement of a job's worth. Four basic methods of comparison are outlined below.

Points system

This system allows jobs to be evaluated quantitatively on the basis of the factors that comprise the demands of the job (e.g. skills, effort, responsibilities and working conditions). This system requires the use of a points manual that describes the factors and the degrees to which these factors may exist within the jobs. It appears to be precise, but quite subjective decisions are involved in the relative weights given to each factor, the graduations within each factor, the choices of factor, and number. The system can be difficult and time consuming. Seeking specialist assistance to design a ranking system of this nature for your organisation is recommended.

Classification system

In this system, jobs are classified according to a series of predetermined wage classifications or grades. The Public Service job classification system is a typical example. The descriptions for each of the job classes constitute the scale against which the specifications for the various jobs are compared.

Job-ranking system

This system ranks jobs on the basis of their relative worth. This is a simplistic approach that indicates the relative importance of jobs; however, it does not reflect the differences in the degree of importance that exists between jobs. Accuracy depends on the evaluator's knowledge of the jobs and on their degree of objectivity. While measuring relative worth, job ranking does not measure the magnitude of difference between jobs.

Job grading system

A refinement on job ranking is job grading. The first step is to use a number of job-related factors (e.g. education, experience and responsibilities) to determine classes or grades of jobs. Generic or 'benchmark' job descriptions are then established for each grade or class. To establish the relative worth of an individual job, it is compared with the benchmark description for each of the grades, and then it is assigned the appropriate grade. It is essential to complete accurate job descriptions for each of the grades.

7.3.2 Key elements of a pay strategy

To establish the correct amount to pay employees, a number of elements need to be considered and met: strategic fit, the need for equity, and is it defensible, affordable, competitive and manageable?

Strategic fit

> supports the climate/culture needed for the organisation
> generates results required to meet the organisation's objectives
> reflects the way in which work is organised
> attracts and motivates the type of people needed to achieve the outcomes.

Equitable

> employees perceive that their pay is fair and equitable
> they understand and support the pay system
> absence of bias.

Defensible

> able to withstand internal and external scrutiny
> based on a consistent framework
> based on valid and credible information.

Competitive

> attracts the skills needed to meet desired outcomes, in line with market rates.

Manageable and affordable

> easy to administer
> meets legislative provisions
> based on a capacity to pay.

7.3.3 Salary surveys

The market will have some influence on pay levels. While job evaluation ensures internal equity, salary surveys determine competitiveness. Consideration of salary survey data may assist in attracting and retaining the right employees for your business. It will enable an organisation to make some comparison against competitors' salary policies and to determine trends in a given industry with regard to reward systems. Some organisations subscribe to a few large surveys to collect data on most or all of the positions in their organisation. Surveys cover different occupational groups in different industries. Essentially, salary surveys provide the raw material for translating job size into dollars, or job pricing. Researching a clerical position and a management function will clearly require different sets of data. For a management position, it is important to consider the results of national surveys to gain more thorough and informative results - analysing more than one source to ensure the validity of the data.

Consider the following aspects when reviewing salary surveys:

> sample size
> uniformity in terminology
> cost/timing
> bias/subjectivity.

Using a professional body that specialises in designing and carrying out salary surveys is critical to gaining accurate information.

7.4 Reward management systems

A number of systems exist under the heading of reward management and performance related pay: merit pay plans, incentive schemes, discretionary bonuses, profit sharing, gain sharing, share plans, competency-based pay and broad- banding.

7.4.1 Merit pay plans

Commonly, under such plans, three points are fixed on a pay scale for a given job: a minimum rate, a mid-point and a maximum rate. Theoretically, employees proceed through the scale (or through a scale with more points) based on a set of pre-determined criteria. Also included under the banner of merit pay plans are programs that score employees out of a certain figure (most commonly 10) and translate this into an earnings differential or an earnings bonus.

A drawback of a plan such as this is that the performance payment gained in one year can become a fixed component of pay in a subsequent year, when performance might be unsatisfactory. Thus, such systems can increase the employee's salary while increasingly becoming divorced from employee behaviour.

7.4.2 Merit bonus plans

These are similar to merit pay plans, except that when an employee reaches the mid-point scale all subsequent payments are of a one-off nature only and are, theoretically, put at risk by poor (or merely satisfactory) performance in subsequent years.

7.4.3 Incentive schemes

Incentive schemes seek to lift employee performance by providing a defined schedule of rewards linked to the achievement of certain pre-determined performance targets. They seek to provide very direct messages to employees that if they achieve certain levels of performance they will receive a certain level of remuneration, or a pre-defined benefit. Such schemes at the lower end include piece-rate plans. Employees receive a direct bonus, or direct payment, based on throughput, such as the number of units produced per day.

Other examples are those for sales and managerial employees. Sales employees often receive direct and predetermined bonuses (or percentages of actual sales) for achieving pre-set targets. Similarly, managerial employees often receive direct benefits for reaching certain budget or production targets.

The advantage of such schemes is that, of necessity, they involve measurements and pre-defined goals, so they provide the organisation with essential control and clarity for the employee. One disadvantage that has been identified in such schemes is that most do not actually place any component of employee salary at risk, operating merely as add-ons to existing fixed base rates. Thus, the incentives in such schemes are often positive only, leaving employees in a position where the failure to achieve goals set does not in itself result in any adverse outcome.

7.4.4 Discretionary bonuses

These bonuses are determined and awarded after desired performances have been achieved and as such make no guarantee that future work or effort will be rewarded in the same way. Such bonuses are usually provided in instances where the organisation has decided to share a portion of the profits/savings with the employees after a particularly good period of performance, or they take the form of a standard annual or end-of-year bonus.

The significant disadvantage of such plans is that they are discretionary and have an inability to focus on individual performance. They also do little to encourage repetition of good performance because, without pre-determined targets, employees do not often understand what they actually did to earn the bonus in the first instance, and are therefore less likely to repeat the performance.

7.4.5 Profit sharing

Profit sharing seeks to align employees to the employer's interests by a sharing of the organisation's profits for a set period, such as a year. This approach encourages a more collaborative and participative style in the workplace. Such schemes seek to align employee effort with the business objectives. The benefit of profit-sharing schemes is that they try to define performance in financial terms, which is tangible and easier to measure. They are not as open to subjectivity or employee misinterpretation, and they can be constructed to be fully funded within future budgets.

Nevertheless, these schemes have prompted some cautions. Profit relates to a number of factors, many of which are completely outside the hands of individual employees. Such schemes often struggle to maintain the transparency of the decision-making necessary to maintain employee confidence. Employees often feel that they have little control over the reward structure and that their individual contribution is unrecognised and unimportant in the global scheme of things. This can lead to employee apathy and a profound reduction of performance motivation.

7.4.6 Gain sharing

Gain sharing is similar to profit sharing, except that the organisation, rather than sharing profit with its employees, accords to them a proportion of a specific area of cost saving. Such schemes have commonly been based on large- scale employee involvement in solving problems of productivity, labour, supply, overheads or quality. Savings are generally distributed according to a pre-determined formula.

An example of such a scheme would be one where an organisation offered to distribute to employees a percentage of any savings made by reducing waste production. While these are attractive programs, analysts have focused on the lack of employee understanding of accounting measures used to identify gains and the lack of control individual employees have over savings outcomes. This misunderstanding has the potential to impact negatively on employee motivation.

7.4.7 Share plans

Employee share plans are schemes that allow employees who meet specific criteria to acquire shares in the company. Share plans may be effective in reward and recognition programs if there is perceived benefit in becoming a shareholder in the company.

The major benefit for the company of share plans is the link between individual performance and company results. Employees who feel they have a stake in the company may be motivated to perform at higher levels than those who have the view that their hard work is creating wealth for others.

Share plans are becoming increasingly popular and come under the banner of long-term systems designed to gradually align employee interests with those of management and the business objectives.

7.4.8 Competency-based pay

Competency-based pay is determined on the basis of evaluating employees on their skill and ability levels. Employees receive pay increases when they progress to the next competency level, but may also be eligible for regular merit increases. The benefits of competency-based pay are that it encourages skills and knowledge acquisition, and draws links between individual performance and progress.

7.4.9 Broad-banding

Broad-banding establishes relatively few broad salary bands. These bands usually represent key stages in career progression within the organisation. The key benefit and objective is flexibility. Broad-banding can open up opportunities for employees by removing levels that may have acted as a barrier to expanding their role and learning new skills.

Movement within a band becomes easier and provides greater challenges and responsibilities.

The approach is particularly beneficial in the remuneration of teams because it allows greater flexibility to reward team members. It is usually combined with competency-based approaches (i.e. an employee’s progress through the bands in steps based on added skills and abilities).

7.5 Factors influencing remuneration and reward

7.5.1 Organisational capacity to attract and retain

Pay systems designed to address recruitment and retention needs have gained mixed support from theorists in remuneration design and management. Traditionally, emphasis was placed on the use of competitive labour market pay rates as a way to deal with employee recruitment and retention. However, research has revealed that a growing number of organisations place increasing emphasis on performance-related pay as a mechanism to recruit and retain labour.

Research reflects that payment of maximum pay levels is not the only way to attract or retain the best employees. Individuals make decisions about jobs based on a number of factors, including: job content, organisation, location, career prospects and personal development. It is a combination of these factors, including remuneration, which influences an individual’s choice.

Organisations, however, must keep abreast with market pay rates for positions within their business. Employers will have difficulty attracting labour if the rates are substantially lower than in other organisations in their industry. So, it is essential for any business to be aware of the rates of pay that competitors are paying for similar positions. Once this information is gathered, an organisation can establish a benchmark position.

Finally, employees may be prompted to leave an organisation if there are perceived inequities in pay. It is important, therefore, to ensure that reliable and consistent decisions are made with respect to salary ranges. This can only be achieved with a carefully-planned strategy that ensures management has the right information to make pay decisions.

7.5.2 Individual needs for equity and financial security

Equity theory takes the position that most people are motivated by their need to be treated fairly. If an individual perceives the return for their input is either greater or less than it should be, they will seek to redress this imbalance by either reducing effort and input, or increasing effort.

O'Neil (1999) describes an equitable reward and recognition system as one that groups and rewards jobs of comparable size within similar ranges. He recommends that the strategy should carefully measure the size of the job, and position it against the relativity of other positions. Jobs of similar size are then graded at the same level or a similar level. There are significant benefits to be gained from a fair treatment policy which increases the organisation's capacity to:

- recruit employees in the open market without creating internal anomalies
- retain good-quality employees
- reward appropriately those who perform effectively. According to O'Neil, the principle of internal consistency requires:
- credible and defensible methods to establish the relative value of each position, thus giving a set of relativities between all jobs
- salary structure that groups jobs of similar size into common pay bands.

Many organisations have adopted a system that incorporates some form of job evaluation. However, for many, the issue of internal equity still remains a problem. The difficulties are varied; for example, in many instances, the system of pay determination is not clearly communicated to employees. Consequently, employees may have the perception that inequities in pay abound when there is disparity in pay levels for people who may, relatively, do the same work.

Other issues relate to the opportunities given to an exclusive set of employees to gain recognition and reward for excellent performance (e.g. programs such as share ownership and bonus payments) which have, in the past, been exclusive to mid to upper-level management.

7.5.3 Industrial legislation

Political and legislative developments provide both opportunities and constraints to Australian businesses. These developments impact on the design of appropriate remuneration strategies and pay-delivery systems. It is important that organisations keep abreast of both commitments and opportunities set by the legislation.

Government policies in relation to enterprise bargaining, the National Employment Standards and the role of Modern Awards in setting minimum terms and conditions of employment lead to developments/changes in industrial legislation. Legislation may impact on the flexibility of employers and employees to agree on terms and conditions that are most attractive and suitable and to prescribing remuneration levels and other terms of employment.

7.5.4 Organisation change

The recurring theme of team-based job design and the need for flexible organisation structures is prompting a critical review of remuneration and reward systems. As organisations review issues such as performance management, they are forced to consider if the remuneration system is supporting the strategic goals. According to Cornish and Adams (1993), the criticism of job evaluation, for example, has been based on its support of a largely bureaucratic, hierarchical structure when there is now great pressure to become flexible, responsive and more streamlined.

Similarly, the criticisms directed at performance pay by Deming (1990) have focused on its reinforcement of competition between employees at a time when teamwork and cooperation are necessary for organisational survival. Theorists and practitioners are supporting management principles based on teams that are highly cohesive and flexible and yet maintain a system that rewards individual performance.

7.6 Designing a reward system

Reward systems are designed to provide return for effort over and above the employee's base salary. The return can be in some form of cash payment: a lump-sum amount, goods or benefits (from very low value to extremely high), other non-monetary gifts or, in some instances, an increase to an individual's base pay. While there is some scepticism about the effectiveness of reward systems in motivating performance, those organisations that invest in careful design, planning and execution of their system clearly benefit.

Taking a strategic approach is the key to a successful system. Issues such as management philosophy, organisation structure and, most importantly, business objectives must be considered in the early stages of design. Developing a clear understanding of the organisation involves consideration of its current values, structure, people, and its goals and vision for the future.

7.6.1 Developing a reward policy

Developing a strategic reward policy helps to prevent managers from making reactive decisions as issues arise. Furthermore, return for the remuneration dollar is greatly improved because the link to the business strategy is more defined. A modern approach to reward management considers numerous factors and involves a range of decision- makers (such as pay and reward specialists), both within and external to the organisation.

Most importantly, management must decide what it wishes to achieve with the reward system. Clearly defined outcomes will help to guide the development of a system, because without them it is impossible to measure and review a new system.

Therefore, a rewards policy should:

- outline the objectives an organisation expects to achieve from the pay and reward system
- provide a list of principles around which the system is developed
- be communicated to all employees
- provide the foundation on which the reward system is designed.

7.6.2 Reward objectives

Although the program objectives will vary from organisation to organisation, there are some common themes that tend to appear in many systems, including:

For the organisation

- assist in the achievement of financial and quality goals

- contribute to business growth and profitability
- attract and retain the quality people needed to meet the business objectives
- motivate employees to improve and sustain high performance levels
- comply with legislative requirements
- ensure optimum value for the remuneration dollar
- maintain competitive pay rates.

For the employee

- ensure fairness and equity
- provide regular performance and salary reviews
- ensure reward decisions are defensible and reliable
- effort and achievements are recognised.

7.6.3 Competency-driven rewards

The first step in developing a competency-based reward system is to identify the competencies that create value for the organisation, and then assign a value. (Refer *Chapter 3.9 Job Analysis, Competencies*.)

The next step is to identify the qualities, attributes and behaviours demonstrated by the excellent performers in the organisation. These should be completed for each job or group of related jobs. The aim is to determine the attributes these employees demonstrate when they successfully complete a task. Finally, the behavioural characteristics that predict the outstanding performance should be identified.

Once the competencies have been identified, they must be tested to clarify that they do, in fact, make a difference. Those competencies are titled 'distinguishing'. Only the distinguishing competencies should be included in the competency-based program. They are generally linked to a base salary. Employees are paid up to a target level, determined by a market rate. This level depends on the employee's understanding and performance of a job. Employees move beyond these rates by acquiring the prescribed competencies.