

# The alignment of compensation and business strategies commerce essay



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Compensation is a key element in the success of any business. Although compensation plans were not always seen as a strategic business initiative, their huge impact on a company's bottom line, recruiting, retaining and motivating people has led to compensation design being considered an important element to achieving success (O'Connell, 2007).

### **The alignment of compensation & business strategies**

It is essential that a fair, competitive and attractive compensation plan is created in order to ensure the future success of the company. If the compensation plan is carried out properly it can ' improve organisational effectiveness, support human capital requirements of a business, and motivate and reward achievement of key corporate strategic and financial goals (O'Connell, 2007: 20). It is thus essential that compensation plans are well thought out and effectively designed. Compensation is the answer to attracting, retaining and motivating employees who have the necessary competencies to carry out the business strategy and handle greater responsibilities (Milkovich, Newman & Gerhart, 2007).

Managers must take note of the rewards that motivate their employees. If this is not done, it may result in a mismatch between the strategies being used by managers to motivate their employees and the motivational rewards that the employees prefer (Arnolds & Venter, 2007). This mismatch, as well as failure on the part of managers and employees to reach common ground in the pursuit of organisational objectives, can result in firms failing to successfully implement their business strategies. Employees will perform at a low level, doing only what is least expected of them when the reward systems are not aligned to their needs. They will not be motivated to put in

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extra effort so that the organisation's goals can be achieved (Arnolds & Venter, 2007). It is therefore important for all firms to regularly assess the rewards that motivate employees.

Different organisations have different compensation policies in place. Matching compensation policies to business strategy leads to greater organisational performance (Montemayor, 1996). Some organisations are quick to introduce a new compensation program based on what they have heard about it. The problem is that it may not fit with their organisation's strategic direction. Only programs that can move the organisation further along its strategic path should be identified and implemented (Kaplan, 2007). Ultimately, compensation strategies seek to either decrease costs or increase revenues relative to competitors (Milkovich et al, 2007).

Compensation professionals play an important role in helping organisations put their business strategies into effect by introducing appropriate compensation plans. ' Compensation experts need to be at the focal point where strategy, organisational effectiveness and human capital management converge' (O'Connell, 2007: 25). It is important that they have a clear understanding of the business, the organisational issues and the direction in which the company is headed. Organisational, employee and business needs must be balanced with the financial and strategic goals of the company. Only then can the right compensation strategy be developed to motivate, reward and sustain high levels of performance. When this balance is found, ' a company can effectively use compensation to execute and achieve desired business results' (O'Connell, 2007: 25).

For example, if a company's strategy is to be innovative, the strategy will focus on new products and a short response time to market trends. The compensation strategy must be tailored to align with the business strategy. A supporting compensation strategy will thus place less emphasis on evaluating skills and jobs and more emphasis will be placed on incentives designed to encourage innovations (Milkovich et al, 2007). A cost cutting business strategy will focus on efficiency and doing more with less. To support the business strategy, the compensation policy will focus on competitor's labour costs, variable pay will be increased and productivity will be emphasised (Milkovich et al, 2007). A company with a customer-focused business strategy will focus on pleasing customers and employees will be paid according to how well they do this. The compensation strategy will thus include customer satisfaction incentives (Milkovich et al, 2007). In order to do better than its competitors, a firm must come up with ways in which it can add value by matching its business and pay strategies. When business strategies change, pay systems must also change (Milkovich et al, 2007). Organisations want to see the returns that they are getting from paying incentives, benefits and even base pay.

Companies are starting to realise that by sharing in the economic gains of achieving targets, they keep employees motivated to reach increasingly difficult goals. When there is a clear line of sight between work and reward, employees will work harder to achieve the goals and receive the rewards (Ulrich, 1997). It has been suggested that ' performance-based pay works best when there is success to share' (Milkovich et al, 2007: 54). An organisation can pay larger bonuses and stock awards when their profits or

market share is on the rise. By paying bonuses fairly, employee attitudes and work behaviours improve, which in turn improves their performance (Milkovich et al, 2007). One of the major challenges in managing total compensation is to understand how the pay system can add value and create a more successful organisation.

## **Internal alignment**

‘ Internal alignment refers to comparisons among jobs or skill levels inside a single organisation. Jobs and people’s skills are compared in terms of their relative contributions to the organisation’s business objectives’ (Milkovich et al, 2007: 19). Internal alignment is not only concerned with the pay rates for employees doing equal work, but also for those employees doing different work. One challenge that managers face is how to determine differences in pay for people doing different work (Milkovich et al, 2007).

An employee’s decision ‘ to stay with the organisation, to become more flexible by investing in additional training, or to seek greater responsibility’ is influenced by the pay that they receive (Milkovich et al, 2007: 19). A compensation system should not stand in the organisation’s way of retaining talented and productive employees. One of the main causes of employee turnover is inadequate compensation (Grobler, Warnich, Carrell, Elbert & Hatfield, 2006). Tensions will result if employees feel that they are not being treated equally and this may cause employees to ‘ reduce their future efforts, change their perceptions regarding rewards for their efforts or leave the organisation (Grobler et al, 2006). Management’s goal is to minimise turnover and lost production due to feelings among employees that they are not being compensated equitably. In order to ensure greater equity among

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jobs, a process known as job evaluation may be embarked upon, whereby a systematic relationship between the pay scales for jobs within an organisation is created. ' Job evaluation is the systematic determination of the relative worth of a job within the organisation that results in an organisation's pay system (Grobler et al, 2006: 404). When comparing jobs, the following factors are taken into account: the skills needed to complete the job, the efforts needed to perform the job, the responsibilities of the job holder, and the working conditions of the job (Grobler et al, 2006). Job evaluation is preformed in order to develop a system of compensation that employees will consider to be fair, and in this way internal consistency among jobs is obtained. Internal consistency thus refers to the relationship between the pay structure, the design of the organisation and the work (Grobler et al, 2006). It is important to design a pay system that ' supports the work flow, is fair to employees and directs their behaviours toward organisation objectives' (Grobler et al, 2006: 404).

Many organisations are dividing their employees and creating different compensation plans for the different employee groups. For example, the executive team will be compensated one way, while a different approach will be used for the sales team, and yet another set of rules will apply to those working in the admin department. In today's business environment, a one-size-fits-all approach is no longer effectiveness (O'Connell, 2007).

Compensation methods have undergone a number of changes over the years such as ' the use of performance pay and other contingent systems of reward, the flattening of pay scales with fewer but broader pay grades and flexible cafeteria-style benefit systems' (Brewster, Carey, Grobler, Holland & <https://assignbuster.com/the-alignment-of-compensation-and-business-strategies-commerce-essay/>

Warnich, 2008). This new approach to compensation is known as strategic pay and is much more suitable to today's changing organisational environments and structures. Strategic pay flows from and implements an organisation's business strategy. The old methods of compensation were associated with 'job-evaluated pay structures, time and seniority' (Brewster et al, 2008: 188). These old methods were appropriate for hierarchical organisations who operated in a stable environment.

Internal pay structures must be designed in such a way that employees will be motivated to achieve the organisation's objectives. There must be a clear line-of-sight between each job and the objectives of the organisation. It is also essential that the structure is fair to all employees (Milkovich et al, 2007). To motivate employees, management can build the following ideas into their strategic pay structure: 'increase the proportion of pay contingent on performance, increase the potency of variable pay by making base salaries only moderately competitive, broaden the range of incentive schemes to include linking pay to group and organisational performance as well as individual performance, identify new performance measures of business success, and introduce flexibility into compensation plans so that rewards extend beyond monetary ones to include prizes and recognition' (Brewster et al, 2008: 188).

Pay structures vary among organisations depending on the number of levels within the organisation, the pay differentials between the levels, and the criteria used to determine the levels and differentials i. e. work content and its value. People are usually paid more if their job requires more knowledge or skills than another job, if their working conditions are unpleasant, or if

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their job adds a great deal of value. One reason for pay differentials is to motivate employees to work towards promotion and a higher-paying level (Milkovich et al, 2007).

Internal structures are shaped by both external and organisation factors. External factors include: ' economic pressures; government policies, laws and regulations; stakeholders; and cultures and customs' (Milkovich et al, 2007: 75). Organisation factors include: ' strategy; technology; human capital; HR policy; employee acceptance; and cost implications' (Milkovich et al, 2007: 75).

With regards to economic pressures, ' one job is paid more or less than another because of differences in relative productivity of the job and differences in how much a consumer values the output' (Milkovich et al, 2007: 76). It will only be worthwhile to employ an additional worker if they can produce a value equal to the value of their wage. This is referred to as marginal productivity (Milkovich et al, 2007). The supply and demand for labour, products and services all affect internal structures. Organisations are constantly forced to redesign their work flow and employees must continuously learn new skills in order to keep up with changes in competitors' products and customers' tastes. ' Unpredictable external conditions require pay structures that support agile organisations and flexible people' (Milkovich et al, 2007: 76).

Government policies, laws and regulations also have an impact on the internal pay structure. Our law gives everybody the right to fair compensation. This is also known as the right to a living wage. Laws have



also been put in place to govern minimum wages (Brewster et al, 2008). Pay-related legislation tries to achieve social welfare objectives by regulating economic forces (Milkovich et al, 2007). The government has influenced compensation ' by legislating pay levels, hours of work, pay for overtime and holidays and non-discriminatory pay practices' (Grobler et al, 2006: 187). The Basic Conditions of Employment Act has a direct impact on a company's compensation strategy.

Unions, stockholders and political groups also influence the internal pay structure. In order to promote solidarity among members, unions generally prefer small differences among jobs and seniority-based promotions. Stockholders compare the salaries paid to executives with the salaries paid to others in the organisation. Stockholders are interested in this difference (Milkovich et al, 2007).

If the pay structure is not aligned to the organisation's strategy it can become an obstacle to the achievement of the organisation's goals. Another factor that has an impact on internal structures is human capital. Human capital refers to ' the education, experience, knowledge, abilities and skills required to perform the work' (Milkovich et al, 2007: 78). The technology used will influence the organisational design, the work that needs to be performed, and the skills or knowledge that is needed to perform the work (Milkovich et al, 2007). The organisation's other HR policies also have an impact on the internal pay structure. The more levels an organisation has, the more promotions it can offer, but the pay differences between the levels may be smaller. It is believed that when promotions take place often, even if they do not include pay increases, employees develop a sense of career

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progress (Milkovich et al, 2007). Some companies develop talent from within the organisation. This also serves to retain top talent. These candidates are promoted when job vacancies arise. The result is that they do not have to employ expensive talent from outside the organisation. It is also easier to manage these individuals as they are already aligned with the culture and business priorities of the organisation. This leads to a greater return on the company's investment (Barnes, 2009).

Another important factor influencing the internal pay structure is whether or not the employees involved accept it. In order to assess the fairness of their pay, employees compare the pay that they receive to that which others receive for doing different jobs in the same internal structure. They also look at what others are paid for doing the same job at competing employers (Milkovich et al, 2007). The procedures for determining the pay structure must be fair as well as the pay structure itself. It has been suggested that employees and managers will accept low pay if they believe that the way in which the pay was determined is fair. It is likely that the pay procedures will be considered fair ' if they are consistently applied to all employees, if employees participated in the process, if appeals procedures are included, and if the data used are accurate' (Milkovich et al, 2007: 80). Pay structures do not stay constant. They change in response to external factors.

An organisation will achieve much better results if the structure is aligned. The structure must be perceived as fair by the employees and it must motivate them to achieve the organisation's goals. If there is a big pay differential between an entry level job and the highest level job in an

organisation, it can encourage employees to stay with the employer and <https://assignbuster.com/the-alignment-of-compensation-and-business-strategies-commerce-essay/>

increase their training and experience. It can also result in greater co-operation with co-workers and for employees to look for more responsibility within the organisation (Milkovich et al, 2007).

## **External competitiveness**

External competitiveness refers to the level of pay that an organisation offers in comparison with its competitors (Montemayor, 1996). This has a huge impact on the attraction and retention of talent as well as on labour cost objectives. With a high pay level, the organisation will be better able to acquire a competent workforce. By increasing the pay level, total labour costs will increase but it may also result in improved labour costs per unit (Montemayor, 1996). The efficiency wage theory states that 'paying above market levels can promote employee motivation that would offset any increment in labour costs' (Montemayor, 1996: 891).

The pay systems of many organisations are market-driven i. e. based on what competitors pay. In the hope of attracting the best applicants, some organisations set their pay levels above that of their competitors (Milkovich et al, 2007). In order to compete with the external market, organisations must ensure that the pay that they are offering is sufficient to attract and retain employees. Employees are likely to leave an organisation if they believe that their pay is not competitive in comparison to what other employers are offering. Organisations must also ensure that they control their labour costs so that they can supply their products and services at a good price and remain competitive in the global economy (Milkovich et al, 2007). It is essential that when companies prepare their business strategies they decide how they are going to compete in the marketplace. For example, <https://assignbuster.com/the-alignment-of-compensation-and-business-strategies-commerce-essay/>

they can choose to compete on price, or they may prefer to differentiate themselves based on products or services, they could even decide to segment the market and only focus on a particular group of buyers.

Understanding the competition is key (Kaplan, 2007).

Employers can better differentiate themselves from their competition by introducing learning and development programs and creating a fun and flexible work environment. These are also known as relational rewards. These initiatives will enhance employee commitment to the organisation (Kaplan, 2007). Employers that are highly-rated usually receive more employment applications as people want to work for the best organisation. The high ratings also result in improved retention of staff and greater profitability as committed employees usually provide better customer service (Kaplan, 2007).

Job applicants who receive more than one offer will compare the offers and the pay scales. More weight is often placed on the salary being offered rather than on the other types of compensation, like benefits and intrinsic rewards (Grobler et al, 2006). In order to remain competitive within the local labour market, employers usually offer salaries that are similar to those offered by competitors. Employers thus need to know what the going rate is for jobs within the local labour market. Wage surveys as well as published market data can be used to determine the average salaries for various positions. These methods assist the organisation in maintaining external consistency with other organisations (Grobler et al, 2006).

An important strategic decision must be made as to whether the organisation should mirror what its competitors are paying, or whether it should design its own pay structure that differs from its competitors but is aligned to the business strategy. The pay level can be set above, below or equal to that of competitors. The mix of pay forms must also be determined relative to those of competitors (Milkovich et al, 2007).

The following three factors shape external competitiveness: labour market factors, product market factors and organisation factors. Together these factors influence pay-level and pay-mix decisions (Milkovich et al, 2007).

As mentioned above, organisations usually claim to be market-driven.

Looking at the demand and supply of labour gives one a greater understanding of how the markets work. The demand side deals with the actions of the employer i. e. the number of new employees they require, and what they are willing and able to pay them. The supply side deals with the potential employees i. e. their qualifications and the pay that they are likely to accept (Milkovich et al, 2007). The market rate is found at the point where the demand for labour meets the supply of labour.

In the short run, the only way that an organisation can change its level of production is by changing its level of human resources. The other factors of production, such as technology, capital and natural resources are fixed in the short run. ' The marginal product of labour is the additional output associated with the employment of one additional person' (Milkovich et al, 2007: 207). However, each additional employee hired will produce less than the previous employee due to the fact that the factors of production are

fixed. Each employee thus has fewer resources to work with. The additional amount that each new employee produces is known as the marginal product (Milkovich et al, 2007). When the marginal product is sold, the money that is generated from the sale is known as marginal revenue. Employers will hire new staff until ' the marginal revenue generated by the last hire is equal to the costs associated with employing that person' (Milkovich et al, 2007: 208). At this point the employer is maximising their profits. Therefore, in order to determine how many people to employ, a manager must establish two things: the pay level that is set by the market forces and the marginal revenue generated by each new employee (Milkovich et al, 2007). This, however, is not so easy to do in reality.

With regards to labour supply, ' the model assumes that many people are seeking jobs, that they possess accurate information about all job openings and that no barriers to mobility exists' (Milkovich et al, 2007: 209). It is not so simple in the real world. For example, the supply curve slopes upward and shows that as pay increases more people will want to take jobs. In the case where unemployment is very low, supply may not increase with offers of higher pay as everybody has a job (Milkovich et al, 2007). The model provides a useful analytical framework but oversimplifies reality.

In certain instances employers pay more than the market-rate. For example, if there are negative elements to a job such as very expensive training, small chances of success, weak job security and unpleasant working conditions, employers may decide to pay higher wages in order to compensate for the negative characteristics. This is referred to as compensating differentials (Milkovich et al, 2007).

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As mentioned above, in terms of the efficiency wage theory, high wages can in fact increase efficiency and lower labour costs. This can be achieved by attracting more qualified applicants and encouraging existing employees to work harder or smarter. It is assumed that the pay level determines effort (Milkovich et al, 2007). An organisation's ability to pay is also an important issue. The greater an organisation's profits in comparison with its competitors the more it is able to share with its employees. These organisations will usually pay more than their competitors and may even pay bonuses in line with their profitability (Milkovich et al, 2007).

Employers can design their pay levels and mix in such a way that a signal is sent to both current and future employees as to the kinds of behaviour that they require. This is known as signaling. For example, if the organisation's base pay is below the market-rate but they offer good bonuses, they may be sending a signal that employees who are risk takers are required. If the organisation pays the market wage and offers no performance-based pay, a different signal is sent and different people are attracted. Signaling helps to communicate expectations (Milkovich et al, 2007).

There are also two theories that help us to understand employee behaviour. A job seeker will not accept a job offer if the wage is below a certain amount irrespective of the other benefits or job attributes. This is known as the reservation wage. It may be above or below the market-rate (Milkovich et al, 2007).

The second theory is the human capital theory. In terms of this theory, those who have improved their productive abilities by investing in themselves

through education, training etc will earn higher wages (Milkovich et al, 2007).

The next factor that shapes external competitiveness is the product market and ability to pay. To a large extent, product market conditions determine what the organisation can afford to pay its employees. The organisation's ability to change what it charges for its products and services is affected by the demand for the product and the amount of competition (Milkovich et al, 2007).

An employer who increases their wage level will either choose to increase its prices, thereby passing the higher labour costs on to consumers, or it can choose to keep prices fixed and pay the increased labour costs out of their revenues. If an employer is operating in a very competitive market they will not easily be able to increase prices (Milkovich et al, 2007).

Lastly, organisation factors include characteristics that are unique to each organisation and their employees such as: industry and technology, employer size, people's preferences and organisational strategy (Milkovich et al, 2007).

' The industry in which an organisation competes influences the technologies used' (Milkovich et al, 2007: 216). Lower wages are paid in labour-intensive industries than in technology-intensive industries. When new technology is introduced within an industry, pay levels are also affected (Milkovich et al, 2007).



Large organisations generally pay more than small ones. In big organisations, talented people have a greater marginal value as they are able to influence more people and decisions resulting in larger profits for the organisation (Milkovich et al, 2007).

‘ Better understanding of employee preferences is increasingly important in determining external competitiveness’ (Milkovich et al, 2007: 217). It is, however, difficult to measure preferences. It has been found that pay is more important to people than they are willing to admit (Milkovich et al, 2007).

With regards to organisation strategy, some employers compete by adopting a low-wage, no services strategy. These organisations, such as Nike and Reebok, often rely on outsourcing to manufacture their products. Other organisations may choose a low-wage, high services strategy or even a high-wage, high services approach (Milkovich et al, 2007). Employers will pay more than their competitors if the job has a direct impact on the success of the organisation. Pay levels will equal that of competitors in jobs that have less of an impact on the success of the organisation. Evidence shows that those organisations with higher-skilled workers who make use of high-performance work practices and computer-based technology also pay higher wages (Milkovich et al, 2007).

## **The integration of internal alignment & external competitiveness**

In order for a compensation strategy to be successful it must blend internal consistency with market competitiveness, and must be structured to recognise the credentials, knowledge and performance of the individuals

involved (Martocchio, 2001). ' An appropriate compensation policy is designed around the organisational structure, competitive position, leadership style and the strategic plan of the organisation' (Santone, Sigler & Britt, 1993: 86).

A mentioned above, one of the main causes of employee turnover is inadequate compensation. ' The competitiveness of pay will affect the organisation's ability to achieve its compensation objectives, and this in turn will affect its performance' (Milkovich et al, 2007: 221). It is common for organisations to match the rates paid by their competitors. If organisations fail to do so, the existing employees will be unhappy and the organisation's ability to recruit will be limited (Milkovich et al, 2007). Such a policy will result in the organisation's wage costs being similar to that of its product competitors and the organisation's ability to attract new employees will thus also be similar to its labour market competitors (Milkovich et al, 2007).

Job evaluation, whereby the worth of a job within an organisation is determined, is performed in order to develop a system of compensation that employees will find fair. In this way, internal consistency among jobs is obtained (Grobler et al, 2006). However, if a competitor is willing to pay an employee a higher wage to do the same work, the employee will leave their current job to earn better pay elsewhere. An employer must therefore not only consider what they are willing to pay for a particular job but also what the competitors are paying for the same job. This is important if they want to attract and retain quality workers.

## **Conclusion**

It is important that companies ensure that their reward systems are aligned with their organisational goals, strategy and culture. Strategic compensation allows for employees to earn incentives if they accomplish company goals. Compensation has a huge effect on recruiting, retaining and motivating people. The compensation strategy of an organisation also has a direct impact on its performance. Internal alignment and external competitiveness should be integrated when forming the pay structure.

## **Practical**

### **Core strategy details**

#### **ABSA**

#### **SARS**

### **Objectives**

- Attract and retain high quality individuals with the optimum mix of skills, competencies and values.
  
- Motivate and reinforce superior performance.
  
- Encourage the development of skills and competencies required to meet current and future objectives.
  
- Employees should share in the success of the business.
  
- Drive productivity, service quality and cost efficiency.
  
- Enable employees to perform at their peak.

-Build a skills inflow through the graduate and youth recruitment programme.

## **Internal alignment**

-Remunerate people fairly and consistently according to their contribution.

-Ensure that employees of equal value are remunerated more or less equally.

-Parity in the immediate environment is the most important.

-Fair remuneration.

-Recognition system.

-Employee development.

-Talent management.

## **Externally competitive**

-Set cost to company (CTC) at the market median.

-Reads the market regularly to strategically position itself at mid-market for fixed remuneration packages with differentiation between employees via variable reward programmes.

-Differentiates aggressively between levels of performance.

-Emphasis on variable pay i. e. incentive and commission schemes.

-Incentive system in place.

## **Employee contributions**

Direct rewards (standard):

Fixed remuneration (CTC), allowances, overtime, leave encashments, variable/ performance based pay (long and short-term incentives).

Direct rewards (non-standard):

Commission.

Indirect reward:

Recognition rewards (prestige awards, service heroes, long service awards).

Bursaries for employees and employee dependants. Benefits: free banking, staff interest rates, disability support fund, leave.

-Fixed remuneration, allowances.

-Overtime.

-Government subsidies.

-Incentive pay.

## **Management**

-Open and transparent communication.

-Objective remuneration decisions.

-Show genuine care and concern.

-Create an enabling environment.

## **Rewards/ compensation strategic map**

**LOW HIGH**

**Objectives Attraction and retention**

**Superior performance**

**Quality service Please see attachment**

**Internal al**