53 Managing Reward Systems

Key concepts and terms

- Added value
- Compa-ratio
- Pay matrix
- Attrition
- Mid-point management
- Total payroll budget

Learning outcomes

On completing this chapter you should be able to define these key concepts. You should also know about:

- Reward forecasting
- Compa-ratio analysis
- Assessing added value
- Conducting individual pay reviews
- Managing the development of reward systems
- Communicating to employees
- Reward budgets
- Attrition analysis
- Conducting general pay reviews
- Reward procedures
- Devolution of pay decisions to line managers

Introduction

Reward management involves the management of complex systems. This is a demanding requirement involving control, evaluation, pay reviews, procedures, the allocation of responsibility and communicating to employees, as explained in this chapter.

Controlling reward

The implementation of reward policies and procedures should be monitored and controlled to ensure that value for money is obtained. Control is easier if the grade and pay structure is well defined and clear guidelines exist on how it and the benefits arrangements should be managed. Control should be based on forecasts, budgets and costings, as described below, and by monitoring and evaluating the implementation of reward policies, as discussed in the next part of this chapter.

Reward forecasts

It is necessary to forecast future payroll costs taking into account the number of people employed and the impact of pay reviews and contingent pay awards. The cost implications of developments such as a revised job evaluation scheme, a new grade and pay structure or a flexible benefits scheme also have to be forecast.

Reward budgets

Pay review budgets set out the increase in payroll costs that will result for either general or individual pay reviews and are used for cost forecasts generally and as the basis for the guidelines issued to line managers on conducting individual reviews.

Total payroll budgets are based on the number of people employed in different jobs and their present and forecast rates of pay. In a budgetary control system they are aggregated from the budgets prepared by departmental managers, but HR provides guidance on the allowances that should be made for pay increases. The aim is to maintain control over payroll costs and restrain managers from the temptation to overpay their staff.

Costing reward processes

Proposed changes to the reward system need to be costed for approval by senior management. The costs would include development costs such as consultants' fees, software, literature, additional staff and, possibly, the opportunity costs arising when staff are seconded to a development project.

Implementation costs also have to be projected. A new grade and pay structure, for example, can easily result in an increase to the payroll of 3 or 4 per cent. New contingent pay schemes may also cost more, although the aim should be to make them self-financing.

Monitoring and evaluating reward policies and practices

The effectiveness of reward policies and practices should be monitored and evaluated against the requirements of the organization. Evaluation should compare outcomes with the objectives set for the new practice (this is why setting objectives for reward initiatives is so important). Monitoring is carried out through compa-ratio analysis, attrition analysis, assessing added value and the use of attitude surveys.

Compa-ratio analysis

A compa-ratio (short for 'comparative ratio') measures the relationship in a graded pay structure between actual and policy rates of pay as a percentage. The policy value used is the midpoint or reference point in a pay range, which represents the 'target rate' for a fully competent individual in any job in the grade. This point is aligned with market rates in accordance with the organization's market stance.

Compa-ratios can be used to define the extent to which pay policy is achieved (the relationship between the policy and actual rates of pay). The analysis of compa-ratios indicates what action may have to be taken to slow down or accelerate increases if compa-ratios are too high or too low compared with the policy level. This is sometimes called 'midpoint management'. Compa-ratios can also be used to measure where an individual is placed in a pay range and therefore provide information on the size of pay increases when a pay matrix is used, as described later in this chapter.

Compa-ratios are calculated as follows:

$$\frac{\text{actual rate of pay}}{\text{mid or reference point of range}} \times 100$$

A compa-ratio of 100 per cent means that actual pay and policy pay are the same. Compa-ratios that are higher or lower than 100 per cent mean that, respectively, pay is above or below the policy target rate. For example, if the target (policy) rate in a range were £20,000 and the average pay of all the individuals in the grade were £18,000, the compa-ratio would be 90 per cent. Compa-ratios establish differences between policy and practice. The reasons for such differences need to be established.

Analysing attrition

Attrition or slippage takes place when employees enter jobs at lower rates of pay than the previous incumbents. If this happens payroll costs will go down, given an even flow of starters and leavers and a consistent approach to the determination of rates of pay. In theory attrition can help to finance pay increases within a range. It has been claimed that fixed incremental systems can be entirely self-financing because of attrition, but the conditions under which this can happen are so exceptional that it probably never happens.

Attrition can be calculated by the formula: total percentage increase to payroll arising from general or individual pay increases minus total percentage increase in average rates of pay. If it can be proved that attrition is going to take place, the amount involved can be taken into account as a means of at least partly financing individual pay increases. Attrition in a pay system with regular progression through ranges, and a fairly even flow of starters and leavers, is typically between 2 and 3 per cent but this should not be regarded as a norm.

Assessing added value

Assessing the added value (ie the value for money) provided by existing practices or by new practices when they are implemented is a major consideration when monitoring and evaluating reward management processes. Evaluating the cost of innovations may lead to the reconsideration of proposals to ensure that they will provide added value. Evaluating the value for money obtained from existing reward practices leads to the identification of areas for improvement.

Affordability is, or should be, a major issue when reviewing reward management developments and existing practices. Added value is achieved when the benefits of a reward practice either exceed its cost or at least justify the cost. At the development stage it is therefore necessary to carry out cost/benefit assessments. The two fundamental questions to be answered are, 'What business needs will this proposal meet?' and 'How will the proposal meet the needs?' The costs and benefits of existing practices should also be assessed on the same basis.

Attitude surveys

An attitude survey is a valuable means of evaluating and monitoring reward practices by assessing the views of those at the receiving end of pay policies as a basis for taking action.

Conducting pay reviews

Pay reviews are general or 'across-the-board' reviews in response to movements in the cost of living or market rates, following pay negotiations with trade unions, individual reviews that determine the pay progression of individuals in relation to their performance or contribution, or individual reviews. They are one of the most visible aspects of reward management (the other is job grading) and are an important means of implementing the organization's reward policies and demonstrating to employees how these policies operate.

Employees expect that general reviews will maintain the purchasing power of their pay by compensating for increases in the cost of living. They will want their levels of pay to be competitive with what they could earn outside. They will also want to be rewarded fairly and equitably for the contribution they make.

General reviews

General reviews take place when employees are given an increase in response to general market rate movements, increases in the cost of living, or union negotiations. General reviews are often combined with individual reviews, but employees are usually informed of both the general and individual components of any increase they receive. Alternatively the general review may be conducted separately to enable better control to be achieved over costs and to focus employees' attention on the performance-related aspect of their remuneration.

Some organizations have completely abandoned the use of across-the-board reviews. They argue that the decision on what people should be paid should be an individual matter, taking into account the personal contribution people are making and their 'market worth' – how they as individuals are valued in the marketplace. This enables the organization to adopt a more flexible approach to allocating pay increases in accordance with the perceived value of individuals to the organization.

The steps required to conduct a general review

1. Decide on the budget.
2. Analyse data on pay settlements made by comparable organizations and rates of inflation.
3. Conduct negotiations with trade unions as required.
4. Calculate costs.
5. Adjust the pay structure – by either increasing the pay brackets of each grade by the percentage general increase or by increasing pay reference points by the overall percentage and applying different increases to the upper or lower limits of the bracket, thus altering the shape of the structure.
6. Inform employees.

Individual reviews

Individual pay reviews determine contingent pay increases or bonuses. The e-reward 2004 survey of contribution pay found that the average size of contingent pay awards made by respondents was 3.3 per cent. Individual awards may be based on ratings, an overall assessment that does not depend on ratings, or ranking, as discussed below.

Individual pay reviews based on ratings

Managers propose increases on the basis of their performance management ratings within a given pay review budget and in accordance with pay review guidelines. Forty-two per cent of the respondents to the CIPD 2003 performance management survey (Armstrong and Baron, 2004) used ratings to inform contingent pay decisions. Approaches to rating were discussed in Chapter 38.

There is a choice of methods. The simplest way is to have a direct link between the rating and the pay increase, for example:

Rating	Percentage increase
A	6
B	4
C	3
D	2
E	0

A more sophisticated approach is to use a pay matrix, as illustrated in Table 53.1. This indicates the percentage increase payable for different performance ratings according to the position of the individual's pay in the pay range. This is sometimes referred to as an individual 'compa-ratio' and expresses pay as a percentage of the midpoint in a range. A compa-ratio of 100 per cent means that the salary would be at the midpoint.

Many people argue that linking performance management too explicitly to pay prejudices the essential developmental nature of performance management. However, realistically it is accepted that decisions on performance-related or contribution-related increases have to be based on some form of assessment. One solution is to 'decouple' performance management and the pay review by holding them several months apart, and 45 per cent of the respondents to the CIPD 2003 survey (Armstrong and Baron, 2004) separated performance management reviews from pay reviews (43 per cent of the respondents to the e-reward 2004 survey separated the review). There is still a read-across but it is not so immediate. Some try to do without formulaic approaches (ratings and pay matrices) altogether, although it is impossible to dissociate contingent pay completely from some form of assessment.

Table 53.1 A pay matrix

Rating	Percentage pay increase according to performance rating and position in pay range (compa-ratio)			
	Position in pay range			
	80%-90%	91%-100%	101%-110%	111%-120%
Excellent	12%	10%	8%	6%
Very effective	10%	8%	6%	4%
Effective	6%	4%	3%	0
Developing	4%	3%	0	0
Ineligible	0	0	0	0

Doing without ratings

Twenty-seven per cent of the respondents to the 2004 e-reward survey of contingent pay did without ratings. The percentage of respondents to the 2003 CIPD performance management survey who did not use ratings was 52 per cent (this figure is too high to be fully reliable and may have been inflated by those who treat service-related increments, which do not depend on ratings, as contingent pay). One respondent to the e-reward survey explained that in the absence of ratings, the approach they used was 'informed subjectivity', which meant considering ongoing performance in the form of overall contribution.

Some companies adopt what might be called an 'holistic' approach. Managers propose where people should be placed in the pay range for their grade, taking into account their contribution and pay relative to others in similar jobs, their potential, and the relationship of their current pay to market rates. The decision may be expressed in the form of a statement that an individual is now worth £30,000 rather than £28,000. The increase is 7 per cent, but what counts is the overall view about the value of a person to the organization, not the percentage increase to that person's pay.

Ranking

Ranking is carried out by managers who place staff in a rank order according to an overall assessment of relative contribution or merit and then distribute performance ratings through the rank order. The top 10 per cent could get an A rating, the next 15 per cent a B rating, and so on. The ratings determine the size of the reward. A forced ranking or 'vitality curve' system may be used to compel managers to conform to predetermined proportions of staff in each grade. But ranking depends on fair, consistent and equitable assessments, which cannot be guaranteed, and assumes that there is some sort of standard distribution of ability across the organization, which may not be the case.

Guidelines for managers on conducting individual pay reviews

Whichever approach is adopted, guidelines have to be issued to managers on how they should conduct reviews. These guidelines will stipulate that they must keep within their budgets and may indicate the maximum and minimum increases that can be awarded with an indication of how awards could be distributed, eg when the budget is 4 per cent overall, it might be suggested that a 3 per cent increase should be given to the majority of their staff and the others given higher or lower increases as long as the total percentage increase does not exceed the budget. Managers in some companies are instructed that they must follow a forced pattern of distribution (a forced choice system) but only 8 per cent of the respondents to the 2003 CIPD survey (Armstrong and Baron, 2004) used this method. To help them to explore alternatives, managers may be provided with a spreadsheet that contains details of the existing rates of staff and which can be used to model alternative distributions on a 'what if' basis. Managers may also be encouraged to 'fine tune' their pay recommendations to ensure that individuals are on the right track within their grade according to their level of performance, competence and time in the job compared with their peers. To do this, they need guidelines on typical rates of progression in relation to performance, skill or competence, and specific guidance on what they can and should do. They also need information on the positions of their staff in the pay structure in relation to the policy guidelines.

Conducting individual pay reviews

Steps required to conduct individual pay review

1. Agree budget.
2. Prepare and issue guidelines on the size, range and distribution of awards and on methods of conducting the review.
3. Provide advice and support.
4. Review proposals against budget and guidelines and agree modifications to them if necessary.
5. Summarize and cost proposals and obtain approval.
6. Update payroll.
7. Inform employees.

It is essential to provide advice, guidance and training to line managers as required. Some managers will be confident and capable from the start. Others will have a lot to learn.

Reward procedures

Reward procedures deal with grading jobs, fixing rates of pay and handling appeals.

Grading jobs

The procedures for grading jobs set out how job evaluation should be used to grade a new job or re-grade an existing one. A point-factor evaluation scheme that has defined grades may be used for all new jobs and to deal with requests for re-grading. However, an analytical matching process (see Chapter 47) may be used to compare the role profiles of the jobs to be graded with grade or level profiles, or profiles of benchmark jobs. This is likely to be the case in large organizations and for broad-banded structures.

Fixing rates of pay on appointment

The procedure should indicate how much freedom line managers and HR have to pay above the minimum rate for the job. The freedom may be limited to, say, 10 per cent above the minimum or two or three pay points on an incremental scale. More scope is sometimes allowed to respond to market rate pressures or to attract particularly well-qualified staff by paying up to the reference point or target salary in a pay range, subject to HR approval and bearing in mind the need to provide scope for contingent pay increases. If recruitment supplements or premiums are used, the rules for offering them to candidates must be clearly defined.

Promotion increases

The procedure will indicate what is regarded as a meaningful increase on promotion, often 10 per cent or more. To avoid creating anomalies, the level of pay has to take account of what other people are paid who are carrying out work at a similar level and it is usual to lay down a maximum level that does not take the pay of the promoted employee above the reference point for the new range.

Appeals

It is customary to include the right to appeal against gradings as part of a job evaluation procedure. Appeals against pay decisions are usually made through the organization's grievance procedure.

Managing the development of reward systems

As Brown (2001) has noted: 'Underneath the glossy jargon in the policy documentation, the reality is that changing pay and benefits practices is a sensitive, difficult and time-consuming exercise.' As a senior reward practitioner explained to e-reward (2003):

> *A key challenge is getting the people in all of the different departments involved in the project – recruitment, employment policy, internal communications, human resources and reward – to work together. If change strategies do not carry everyone in the organization willingly forward, the process can be painful and even damaging. So it's vital that the reward manager builds relationships with the right people. You need to get key individuals to work together without them feeling that they are losing control of their initiatives. Never underestimate the value of in-depth employee consultation. It is necessary to spend money on professional research – market research, HR consultants to design and facilitate focus groups – as though you are conducting a market research exercise. Employees are consumers. You need to sell the initiative to them and help them understand why it is taking place.*

Developing reward systems is indeed a complex process, as illustrated in Figure 53.1. Throughout the sequence of events shown there, it is essential to communicate with and involve the stakeholders – top management, line managers, employees and employee representatives.

Devolution to line managers of responsibility for reward

The trend is to devolve more authority to line managers for pay decisions dealing with pay increases awarded in periodical individual pay reviews and, less commonly, fixing rates of pay on appointment or promotion. Authority is generally constrained by the requirement to keep within strictly defined budget limits. Line managers will be required to make decisions that are in accordance with policy guidelines. The amount of authority devolved can vary widely.

Reasons for devolution

The reasons for devolving more authority for pay decisions to line managers are as follows:

- the trend generally to devolve more decision-making authority and accountability to line managers;

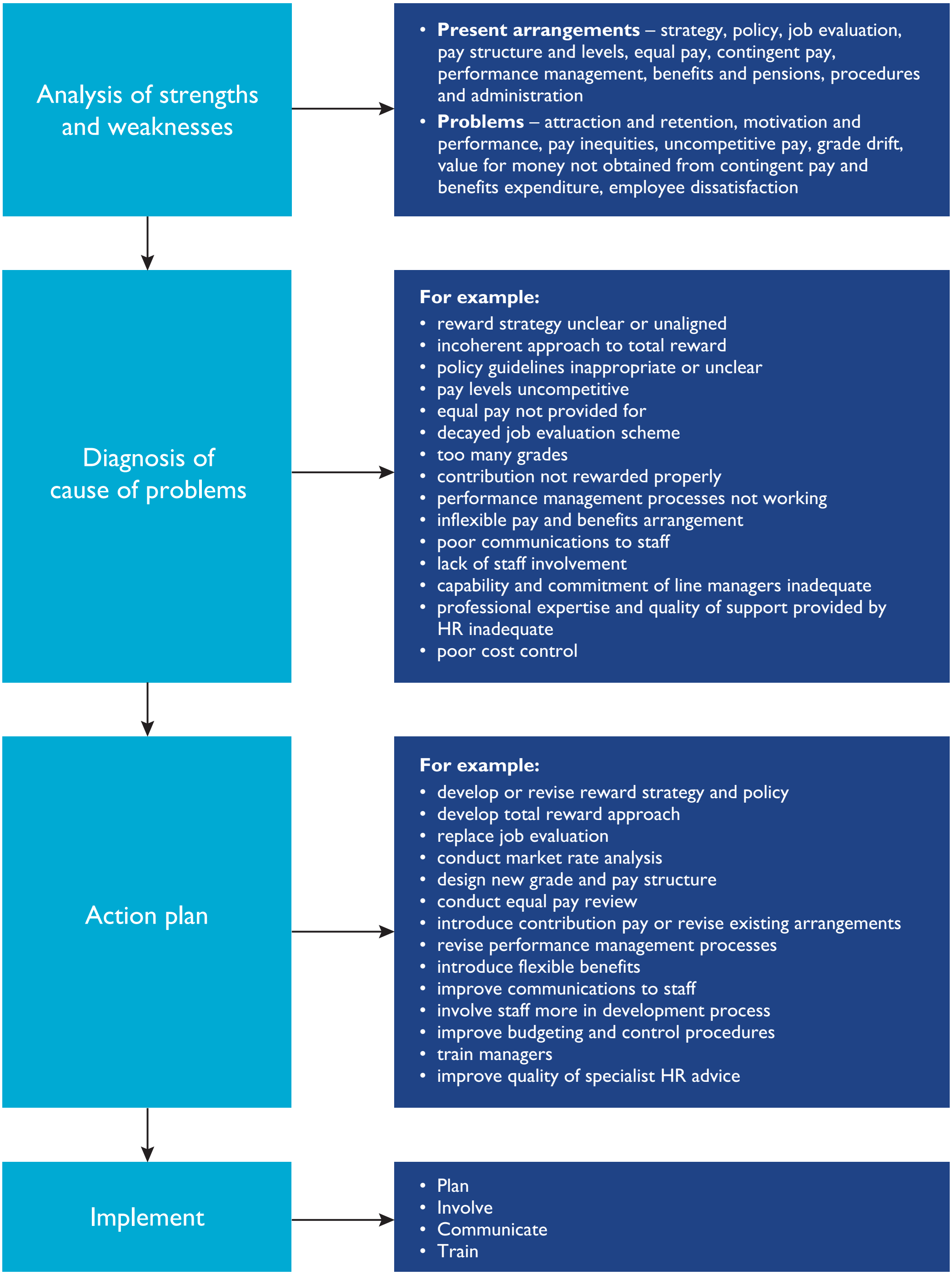

Figure 53.1 Development of reward system

- the belief that if managers are to be held accountable for the management of their resources and the performance of their teams they ought to be given scope to determine, within the guidelines, how team members should be rewarded;
- delayering in organizations has forced more decision making onto line managers;
- a generally more flexible approach to reward management means that rigid centralized control of pay is no longer appropriate;
- line managers are close to individual employees and are in the best position to know how they should be valued.

Guidelines

Pay review guidelines can spell out the basis upon which decisions should be made and the way awards should be distributed. For example, it might be stated that the normal distribution of awards is as follows: 70 per cent receive the average reward of, say, 3 per cent; 20 per cent can be given an above average award of, say, between 4 per cent and 6 per cent; and 10 per cent can be given a below average reward. If the policy is to provide a reasonable amount of leeway, these guidelines might be treated as indicative only; managers would be able to recommend deviations from them as long as these were objectively justified and the total amount awarded to their staff did not exceed the budget. In addition, the HR department usually monitors proposed increases and asks managers to justify any deviations from the norm.

Guidelines on fixing salaries may limit the discretion to pay more than a defined amount, eg up to 10 per cent above the pay range minimum, if this is believed to be necessary to attract someone or provide a person with an adequate promotion increase. Managers may have the right to make out a case for paying more.

Problems with devolution

The arguments for devolving more authority to line managers for pay decisions are powerful but there are a number of problems, namely:

- the danger of managers making biased, unfair or ill-informed judgements is increased;
- it may become much more difficult to achieve a reasonable degree of consistency across departments;
- it is difficult to achieve the right balance between centralized direction and control (to achieve consistency) and freedom for managers to make their own decisions.

Dealing with the problems

It would be most unusual for any organization to give unlimited freedom to line managers. The least that can be done is to control payroll costs by requiring managers to keep within their budgets. Beyond that, in any organization where top management does not operate hands-on control of all decisions (which means almost every organization), there have to be some guidelines, such as those mentioned above and explained in more detail earlier in this chapter (fixing rates of pay) and individual pay reviews. The culture of the organization and its management style will determine how exacting those guidelines will be but, if it is believed that devolution is desirable, then some freedom to act should be provided within the guidelines. However, it is still necessary for the HR department to monitor proposed increases. Such monitoring might have to be fairly tight when devolution first takes place or for newly appointed managers, although it should be relaxed when it is believed that managers will act responsibly.

Communicating to employees

Transparency is important. Employees need to know how reward policies will affect them and how pay and grading decisions have been made. They need to be convinced that the system is fair.

Communicating to employees collectively

Employees and their representatives should be informed about the guiding principles and policies that underpin the reward system and the reward strategies that drive it. They should understand the grade and pay structure, how grading decisions are made, including the job evaluation system, how their pay can progress within the structure, the basis upon which contingent pay increases are determined, and policies on the provision of benefits including details of a flexible benefits scheme if one is available.

Communicating to individual employees

Individual employees should understand how their grade, present rate of pay and pay increases have been determined and the pay opportunities available to them – the scope for pay progression and how their contribution will be assessed through performance management. They should be informed of the value of the benefits they receive so that they are aware of their total remuneration and, if appropriate, how they can exercise choice over the range or scale of their benefits through a flexible benefits scheme.

Managing reward systems – key learning points

Reward forecasting

It is necessary to forecast future payroll costs, taking into account the number of people employed and the impact of pay reviews and contingent pay awards.

Reward budgets

Pay review budgets set out the increase in payroll costs that will result for either general or individual pay. Total payroll budgets are based on the number of people employed in different jobs and their present and forecast rates of pay.

Compa-ratio analysis

Compa-ratios can be used to define the extent to which pay policy is achieved (the relationship between the policy and actual rates of pay) The analysis of compa-ratios indicates what action may have to be taken to slow down or accelerate increases if compa-ratios are too high or too low compared with the policy level.

Attrition analysis

Attrition can be calculated by the formula: total percentage increase to payroll arising from general or individual pay increases minus total percentage increase in average rates of pay. If it can be proved that attrition is going to take place, the amount involved can be taken into account as a means of at least partly financing individual pay increases.

Assessing added value

Assessing the added value (ie the value for money) provided by existing practices or by new practices when they are implemented is a major consideration when monitoring and evaluating reward management processes.

Conducting general pay reviews

General reviews take place when employees are given an increase in response to general market rate movements, increases in the cost of living, or union negotiations. The steps are:

1. Decide on the budget.
2. Analyse data on pay settlements.
3. Conduct negotiations with trade unions.
4. Calculate costs.
5. Adjust the pay structure.
6. Inform employees.

Conducting individual pay reviews

1. Agree budget.
2. Prepare and issue guidelines on the size, range and distribution of awards and on methods of conducting the review.
3. Provide advice and support.
4. Review proposals against budget and guidelines and agree modifications to them if necessary.
5. Summarize and cost proposals and obtain approval.
6. Update payroll.
7. Inform employees.

Managing reward systems – key learning points (continued)

Reward procedures

Reward procedures deal with grading jobs, fixing rates of pay and handling appeals.

Managing the development of reward systems

See Figure 53.1.

Devolution of pay decisions to line managers

The trend is to devolve more authority to line managers for pay decisions dealing with pay increases awarded in periodical individual pay reviews and, less commonly, fixing rates of pay on appointment or promotion. But it is necessary to ensure that decisions are fair and consistent.

Communicating to employees

Transparency is important. Employees need to know how reward policies will affect them and how pay and grading decisions have been made. They need to be convinced that the system is fair.

Questions

1. From a member of your CIPD branch: 'I have just been asked to take on responsibility for reward management. One of the things my predecessor mentioned was the importance of keeping the midpoint management system going. Can you please tell me what midpoint and midpoint management are and why they are important?'
2. From the director of finance: 'Please tell me what steps can be taken to control the ever-increasing costs arising from our pay arrangements. As a local authority we seem to be landed with a fixed incremental system which, as labour turnover is low, means that the majority of people are at or near the top of their scale without, as I see it, necessarily having earned it in terms of value-adding performance'.
3. From the chief executive: 'What are the arguments for and against instituting a fixed distribution system for performance ratings to improve our ability to control payroll costs?'
4. From the director of personnel: 'Please let me know how you propose to ensure that the introduction of our new broad-graded pay structure runs smoothly.'

References

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