



# Part IX

## Rewarding people

*This part is concerned with the process of rewarding people in organizations. It starts in Chapter 42 with a general review of reward management, which includes descriptions of its application for directors and executives, sales staff and manual workers. This is followed in Chapter 43 with an examination of the concept of strategic reward. The rest of Part IX deals with the following aspects of reward management:*

*Chapter 44 – Job evaluation*

*Chapter 45 – Market rate analysis*

*Chapter 46 – Grade and pay structures*

*Chapter 46 – Contingent pay*

*Chapter 47 – Employee benefits, pensions and allowances*

*Chapter 48 – Managing reward systems*

# Reward management

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This chapter provides an overview of reward management. The concept of reward management, its strategic and detailed aims and its philosophy are discussed initially. Reference is also made to the economic factors that affect levels of pay. This is followed by descriptions of the elements of a reward management system and the concept of total reward. The chapter ends with descriptions of particular applications of reward management for directors and executives, sales staff and manual workers.

## REWARD MANAGEMENT DEFINED

Reward management is concerned with the formulation and implementation of strategies and policies, the purposes of which are to reward people fairly, equitably and consistently in accordance with their value to the organization and thus help the organization to achieve its strategic goals. It deals with the design, implementation and maintenance of reward systems (reward processes, practices and procedures) that aim to meet the needs of both the organization and its stakeholders.

## THE AIMS OF REWARD MANAGEMENT

The aims of reward management are to:

- reward people according to what the organization values and wants to pay for;
- reward people for the value they create;
- reward the right things to convey the right message about what is important in terms of behaviours and outcomes;
- develop a performance culture;
- motivate people and obtain their commitment and engagement;
- help to attract and retain the high quality people the organization needs;
- create total reward processes that recognize the importance of both financial and non-financial rewards;
- develop a positive employment relationship and psychological contract;
- align reward practices with both business goals and employee values; as Brown (2001) emphasizes, the 'alignment of your reward practices with employee values and needs is every bit as important as alignment with business goals, and critical to the realization of the latter';
- operate fairly – people feel that they are treated justly in accordance with what is due to them because of their value to the organization: the 'felt-fair' principle of Jaques (1961);
- apply equitably – people are rewarded appropriately in relation to others within the organization, relativities between jobs are measured as objectively as possible and equal pay is provided for work of equal value;
- function consistently – decisions on pay do not vary arbitrarily and without due cause between different people or at different times;
- operate transparently – people understand how reward processes operate and how they are affected by them.

## THE PHILOSOPHY OF REWARD MANAGEMENT

Reward management is based on a well-articulated philosophy – a set of beliefs and guiding principles that are consistent with the values of the organization and help to enact them. These include beliefs in the need to achieve fairness, equity, consistency and transparency in operating the reward system. The philosophy recognizes that if HRM is about investing in human capital from which a reasonable return is required, then it is proper to reward people differentially according to their contribution (ie the return on investment they generate).

The philosophy of reward management recognizes that it must be strategic in the sense that it addresses longer-term issues relating to how people should be valued for what they do and what they achieve. Reward strategies and the processes that are required to implement them have to flow from the business strategy.

Reward management adopts a 'total reward' approach, which emphasizes the importance of considering all aspects of reward as a coherent whole that is integrated with other HR initiatives designed to achieve the motivation, commitment, engagement and development of employees. This requires the integration of reward strategies with other HRM strategies, especially those concerning human resource development. Reward management is an integral part of an HRM approach to managing people.

The philosophy will be affected by the business and HR strategies of the organization, the significance attached to reward matters by top management, and the internal and external environment of the organization. The external environment includes the levels of pay in the labour market (market rates) and it is helpful to be aware of the economic theories that explain how these levels are determined, as summarized in Table 42.1.

## THE ELEMENTS OF REWARD MANAGEMENT

The elements of reward management are described below.

### *Reward system*

A reward system consists of:

- *Policies* that provide guidelines on approaches to managing rewards.
- *Practices* that provide financial and non-financial rewards.
- *Processes* concerned with evaluating the relative size of jobs (job evaluation) and assessing individual performance (performance management).
- *Procedures* operated in order to maintain the system and to ensure that it operates efficiently and flexibly and provides value for money.

### *Reward strategy*

Reward strategy sets out what the organization intends to do in the longer term to develop and implement reward policies, practices and processes that will further the achievement of its business goals.

**Table 42.1** Economic theories explaining pay levels

Name of theory	Summary of theory	Practical significance
The law of supply and demand	Other things being equal, if there is a surplus of labour and supply exceeds the demand, pay levels go down; if there is a scarcity of labour and demand exceeds the supply, pay goes up.	Emphasizes the importance of labour market factors in affecting market rates.
Efficiency wage theory	Firms will pay more than the market rate because they believe that high levels of pay will contribute to increases in productivity by motivating superior performance, attracting better candidates, reducing labour turnover and persuading workers that they are being treated fairly. This theory is also known as ‘the economy of high wages’.	Organizations use efficiency wages theory (although they will not call it that) when they formulate pay policies which place them as market leaders or at least above the average.
Human capital theory	A worker has a set of skills developed by education and training which generates a stock of productive capital.	Employees and employers each derive benefits from investment in creating human capital. The level of pay should supply both parties with a reasonable return on that investment.
Agency theory	The owners of a firm (the principals) are separate from the employees (the agents). This difference can create ‘agency costs’ because the agents may not be so productive as the principals. The latter therefore have to devise ways of motivating and controlling the efforts of the former.	A system of incentives to motivate and reward acceptable behaviour. This process of ‘incentive alignment’ consists of paying for measurable results that are deemed to be in the best interests of the owners.
The effort bargain	Workers aim to strike a bargain about the relationship between what they regard as as reasonable contribution and what their employer is prepared to offer to elicit that contribution.	Management has to assess what level and type of inducements it has to offer in return for the contribution it requires from its workforce.

## *Reward policies*

Reward policies address the following broad issues:

- the level of rewards, taking into account 'market stance', ie how internal rates of pay should compare with market rates, for example aligned to the median or the upper quartile rate;
- achieving equal pay;
- the relative importance attached to external competitiveness and internal equity;
- the approach to total reward;
- the scope for the use of contingent rewards related to performance, competence, contribution or skill;
- the role of line managers;
- transparency – the publication of information on reward structures and processes to employees.

## *Total reward*

Total reward is the combination of financial and non-financial rewards available to employees.

## *Total remuneration*

Total remuneration is the value of all cash payments (total earnings) and benefits received by employees.

## *Base or basic pay*

The base rate is the amount of pay (the fixed salary or wage) that constitutes the rate for the job. It may be varied according to the grade of the job or, for manual workers, the level of skill required.

Base pay will be influenced by internal and external relativities. The internal relativities may be measured by some form of job evaluation. External relativities are assessed by tracking market rates. Alternatively, levels of pay may be agreed through collective bargaining with trade unions or by reaching individual agreements.

Base pay may be expressed as an annual, weekly or hourly rate. For manual workers this may be called a 'time rate' system of payment. Allowances for overtime, shift working, unsocial hours or increased cost of living in London or elsewhere may be added to base pay. The base rate may be adjusted to reflect increases in the cost of living or market rates by the organization, unilaterally or by agreement with a trade union.

### *Job evaluation*

Job evaluation is a systematic process for defining the relative worth or size of jobs within an organization in order to establish internal relativities and provide the basis for designing an equitable grade structure, grading jobs in the structure and managing relativities. It does not determine the level of pay directly. Job evaluation can be analytical or non-analytical. It is based on the analysis of jobs or roles, which leads to the production of job descriptions or role profiles. Job evaluation is described in Chapter 44.

### *Market rate analysis*

Market rate analysis is the process of identifying the rates of pay in the labour market for comparable jobs to inform decisions on levels of pay within the organization. A policy decision may be made on how internal rates of pay should compare with external rates – an organization's market stance. Market rate analysis is described in Chapter 45.

### *Grade and pay structures*

Jobs may be placed in a graded structure according to their relative size. Pay levels in the structure are influenced by market rates. The pay structure may consist of pay ranges attached to grades, which provide scope for pay progression based on performance, competence, contribution or service. Alternatively, a 'spot rate' structure may be used for all or some jobs in which no provision is made for pay progression in a job. The various types of grade and pay structures are described in Chapter 46.

### *Contingent pay*

Additional financial rewards may be provided that are related to performance, competence, contribution, skill or experience. These are referred to as 'contingent pay'. Contingent payments may be added to base pay, ie 'consolidated'. If such payments are not consolidated (ie paid as cash bonuses) they are described as 'variable pay'. Contingent pay schemes are described in Chapter 47.

### *Employee benefits*

Employee benefits include pensions, sick pay, insurance cover, company cars and a number of other 'perks' as described in Chapter 48. They comprise elements of remuneration additional to the various forms of cash pay and also include provisions for employees that are not strictly remuneration, such as annual holidays.

### *Performance management*

Performance management processes (see Part VII) define individual performance and contribution expectations, assess performance against those expectations, provide for regular constructive feedback and result in agreed plans for performance improvement, learning and personal development. They are a means of providing non-financial motivation and may also inform contingent pay decisions.

### *Non-financial rewards*

These are rewards that do not involve any direct payments and often arise from the work itself, for example, achievement, autonomy, recognition, scope to use and develop skills, training, career development opportunities and high quality leadership.

The inter-relationships of these elements are shown in Figure 42.1.

## TOTAL REWARD

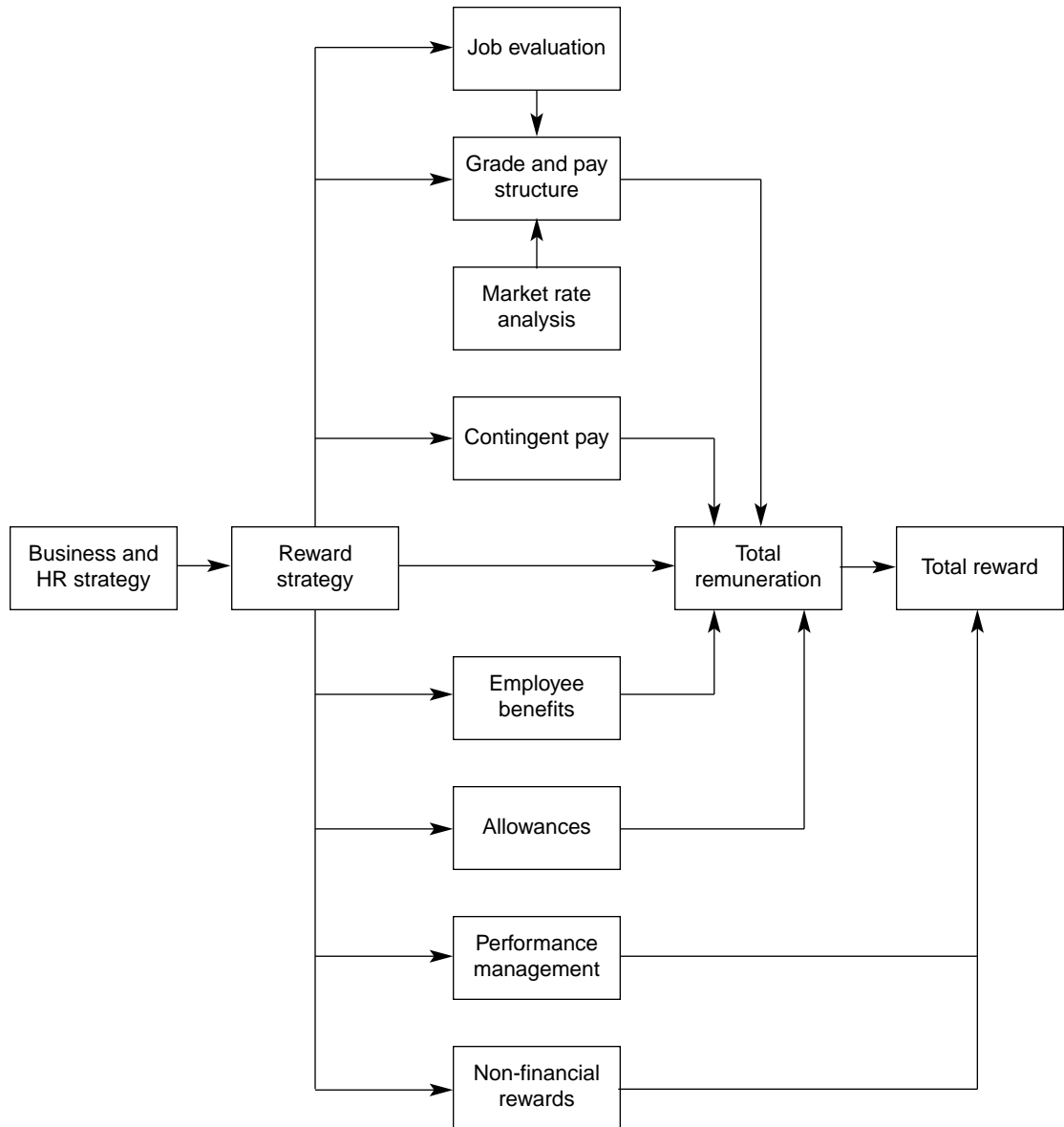
The concept of total reward has emerged quite recently and is exerting considerable influence on reward management. This section of the chapter begins by defining what it means. The importance of the concept is then explained, and the section continues with an analysis of the components of total reward. It concludes with a description of how a total reward approach to reward management can be developed.

### *Total reward defined*

As defined by Manus and Graham (2003), total reward 'includes all types of rewards – indirect as well as direct, and intrinsic as well as extrinsic'. Each aspect of reward, namely base pay, contingent pay, employee benefits and non-financial rewards, which include intrinsic rewards from the work itself, are linked together and treated as an integrated and coherent whole. Total reward combines the impact of the two major categories of reward as defined below and illustrated in Figure 42.2: 1) *transactional rewards* – tangible rewards arising from transactions between the employer and employees concerning pay and benefits; and 2) *relational rewards* – intangible rewards concerned with learning and development and the work experience.

A total reward approach is holistic: reliance is not placed on one or two reward mechanisms operating in isolation, and account is taken of every way in which people can be rewarded and obtain satisfaction through their work. The aim is to





**Figure 42.1** Reward management: elements and interrelationships

maximize the combined impact of a wide range of reward initiatives on motivation, commitment and job engagement. As O’Neal (1998) has explained: ‘Total reward embraces everything that employees value in the employment relationship.’

Transactional rewards	Base pay	Total remuneration	Total reward
	Contingency pay		
	Employee benefits		
Relational rewards	Learning and development	Non-financial/ intrinsic rewards	
	The work experience		

**Figure 42.2** The components of total reward

An equally wide definition of total reward is offered by WorldatWork (2000) who state that total rewards are ‘all of the employer’s available tools that may be used to attract, retain, motivate and satisfy employees’. Thompson (2002) suggests that:

Definitions of total reward typically encompass not only traditional, quantifiable elements like salary, variable pay and benefits, but also more intangible non-cash elements such as scope to achieve and exercise responsibility, career opportunities, learning and development, the intrinsic motivation provided by the work itself and the quality of working life provided by the organization.

The conceptual basis of total rewards is that of configuration or ‘bundling’, so that different reward processes are interrelated, complementary and mutually reinforcing. Total reward strategies are vertically integrated with business strategies, but they are also horizontally integrated with other HR strategies to achieve internal consistency.

### *The significance of total reward*

Essentially, the notion of total reward says that there is more to rewarding people than throwing money at them.

For O'Neal (1998), a total reward strategy is critical to addressing the issues created by recruitment and retention as well as providing a means of influencing behaviour:

It can help create a work experience that meets the needs of employees and encourages them to contribute extra effort, by developing a deal that addresses a broad range of issues and by spending reward dollars where they will be most effective in addressing workers' shifting values.

Perhaps the most powerful argument for a total rewards approach was made by Pfeffer (1998):

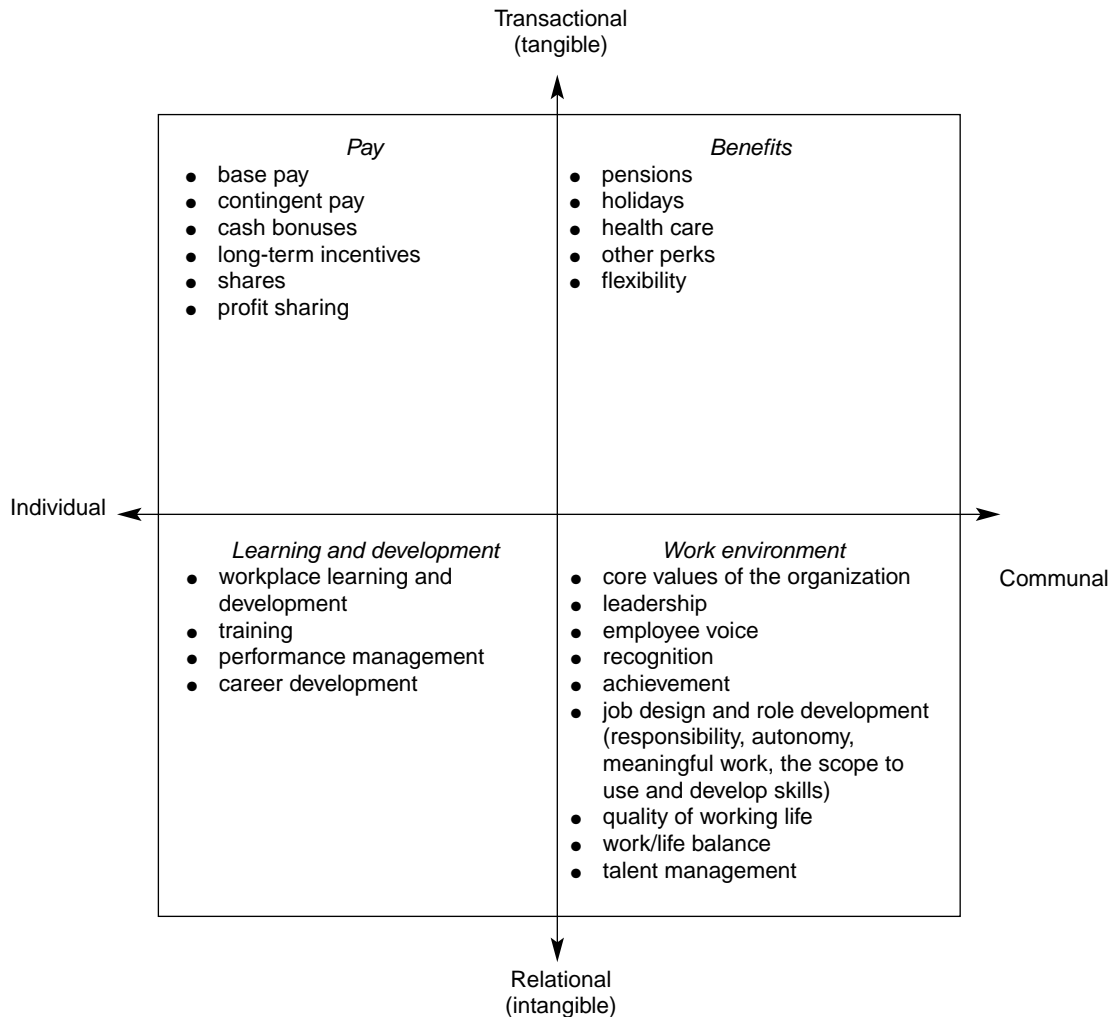
Creating a fun, challenging, and empowered work environment in which individuals are able to use their abilities to do meaningful jobs for which they are shown appreciation is likely to be a more certain way to enhance motivation and performance – even though creating such an environment may be more difficult and take more time than simply turning the reward lever.

The benefits of a total reward approach are:

- *Greater impact* – the combined effect of the different types of rewards will make a deeper and longer-lasting impact on the motivation and commitment of people.
- *Enhancing the employment relationship* – the employment relationship created by a total reward approach makes the maximum use of relational as well as transactional rewards and will therefore appeal more to individuals.
- *Flexibility to meet individual needs* – as pointed out by Bloom and Milkovitch (1998): 'Relational rewards may bind individuals more strongly to the organization because they can answer those special individual needs.'
- *Talent management* – relational rewards help to deliver a positive psychological contract and this can serve as a differentiator in the recruitment market that is much more difficult to replicate than individual pay practices. The organization can become an 'employer of choice' and 'a great place to work', thus attracting and retaining the talented people it needs.

## MODEL OF TOTAL REWARD

A model of total reward is shown in Figure 42.3.



**Figure 42.3** Model of total reward

The upper two quadrants – pay and benefits – represent transactional rewards. These are financial in nature and are essential to recruit and retain staff but can be easily copied by competitors. By contrast, the relational (non-financial) rewards produced

by the lower two quadrants are essential to enhancing the value of the upper two quadrants. The real power, as Thompson (2002) states, comes when organizations combine relational and transactional rewards.

## REWARD MANAGEMENT FOR DIRECTORS AND EXECUTIVES

### *Principles of corporate governance relating to remuneration of directors*

The key principles of corporate governance as it affects the remuneration of directors, which emerged from various reviews, namely the Cadbury, Greenbury and Hampel Reports, are as follows:

- Remuneration committees should consist exclusively of non-executive directors. Their purpose is to provide an independent basis for setting the salary levels and the rules covering incentives, share options, benefit entitlements and contract provisions for executive directors. Such committees are accountable to shareholders for the decisions they take and the non-executive directors who sit on them should have no personal financial interests at stake. They should be constituted as sub-committees of company boards and boards should elect both the chairman and the members.
- Remuneration committees must provide a remuneration package sufficient to attract, retain and motivate directors but should avoid paying more than is necessary. They should be sensitive to wider issues, eg pay and employment conditions elsewhere in the company.
- Remuneration committees should take a robust line on the payment of compensation where performance has been unsatisfactory.
- Performance-related elements should be designed to align the interests of directors and shareholders.
- Any new longer-term incentive arrangement should, preferably, replace existing executive share option plans, or at least form part of an integrated approach, which should be approved by shareholders.
- The pension consequences and associated costs to the company of increases in base salary should be considered.
- Notice or service contract periods should be set at, or reduced to, a year or less. However, in some cases periods of up to two years may be acceptable.

## *Elements of directors' and senior executives' pay*

The main elements of directors' and senior executives' pay are basic pay, bonus or incentive schemes, share option and share ownership schemes.

### **Basic pay**

Decisions on the base salary of directors and senior executives are usually founded on largely subjective views about the market worth of the individuals concerned. Remuneration on joining the company is commonly settled by negotiation, often subject to the approval of a remuneration committee. Reviews of base salaries are then undertaken by reference to market movements and success as measured by company performance. Decisions on base salary are important not only in themselves but also because the level may influence decisions on the pay of both senior and middle managers. Bonuses are expressed as a percentage of base salary, share options may be allocated as a declared multiple of basic pay and, commonly, pension will be a proportion of final salary.

### **Bonus schemes**

Virtually all major employers in the UK (90 per cent according to recent surveys by organizations such as Monks and Hay) provide annual incentive (bonus) schemes for senior executives. Bonus schemes provide directors and executives with cash sums based on the measures of company and, frequently, individual performance.

Typically, bonus payments are linked to achievement of profit and/or other financial targets and they are sometimes 'capped', ie a restriction is placed on the maximum amount payable. There may also be elements related to achieving specific goals and to individual performance.

### **Share option schemes**

Many companies have share option schemes that give directors and executives the right to buy a block of shares on some future date at the share price ruling when the option was granted. They are a form of long-term incentive on the assumption that executives will be motivated to perform more effectively if they can anticipate a substantial capital gain when they sell their shares at a price above that prevailing when they took up the option.

### **Executive restricted share schemes**

Under such schemes free shares are provisionally awarded to participants. These

shares do not belong to the executive until they are released or vested; hence they are 'restricted'. The number of shares actually released to the executive at the end of a defined period (usually three or, less commonly, five years) will depend on performance over that period against specific targets. Thereafter there may be a further retention period when the shares must be held, although no further performance conditions apply.

## REWARD MANAGEMENT FOR SALES STAFF

There are no hard-and-fast rules governing how sales representatives should be paid. It depends on the type of company, the products or services it offers its customers and the nature of the sales process – how sales are organized and made. The different methods are described in Table 42.2.

## PAYING MANUAL WORKERS

The pay of manual workers takes the form of time rates, also known as day rates, day work, flat rates or hourly rates. Incentive payments by means of payment-by-results schemes may be made on top of a base rate.

### *Time rates*

These provide workers with a predetermined rate for the actual hours they work. Time rates on their own are most commonly used when it is thought that it is impossible or undesirable to use a payment-by-results system, for example in maintenance work. From the viewpoint of employees, the advantage of time rates is that their earnings are predictable and steady and they do not have to engage in endless arguments with rate-fixers and supervisors about piece rate or time allowances. The argument against them is that they do not provide a direct incentive relating the reward to the effort or the results. Two ways of modifying the basic time rate approach are to adopt high day rates, as described below, or measured day work.

Time rates may take the form of what are often called high day rates. These are higher than the minimum time rate and may contain a consolidated bonus rate element. The underlying assumption is that higher base rates will encourage greater effort without the problems created when operating an incentive scheme. High day rates are usually above the local market rates, to attract and retain workers.

**Table 42.2** Summary of payment and incentive arrangements for sales staff

Method	Features	Advantages	Disadvantages	When appropriate
Salary only	Straight salary, no commission or bonus	Encourage customer service rather than high pressure selling; deal with the problem of staff who are working in a new or unproductive sales territory; protects income when sales fluctuate for reasons beyond the individual's control	No direct motivation through money; may attract under-achieving people who are subsidized by high achievers; increases fixed costs of sales because pay costs are not flexed with sales results	When representing the company is more important than direct selling; staff have little influence on sales volume (they may simply be 'order takers'); customer service is all-important
Salary plus commission	Basic salary plus cash commission calculated as a percentage of sales volume or value	Direct financial motivation is provided related to what sales staff are there, to do ie generate sales; but they are not entirely dependent on commission – they are cushioned by their base salary	Relating pay to the volume or value of sales is too crude an approach and may result in staff going for volume by concentrating on the easier to sell products not those generating high margins; may encourage high-pressure selling as in some financial services firms in the 1980s and 1990s	When it is believed that the way to get more sales is to link extra money to results but a base salary is still needed to attract the many people who want to be assured of a reasonable basic salary which will not fluctuate but who still aspire to increase that salary by their own efforts
Salary plus bonus	Basic salary plus cash bonus based on	Provide financial motivation but targets or	Do not have a clear line of sight between	When: flexibility in providing rewards is

*continued overleaf*



Table 42.2 *continued*

Method	Features	Advantages	Disadvantages	When appropriate
	achieving and exceeding sales targets or quotas and meeting other selling objectives	objectives can be flexed to ensure that particular sales goals are achieved, eg high margin sales, customer service	effort and reward; may be complex to administer; sales representative may find them hard to understand and resent the use of subjective judgements on performance other than sales	important; it is felt that sales staff need to be motivated to focus on aspects of their work other than simply maximizing sales volume
Commission only	Only commission based on a percentage of sales volume or value is paid, there is no basic salary	Provide a direct financial incentive; attract high performing sales staff; ensure that selling costs vary directly with sales; little direct supervision required	Lead to high-pressure selling; may attract the wrong sort of people who are interested only in making sales and not customer service; focus attention on high volume rather than profitability	When: sales performance depends mainly on selling ability and can be measured by immediate sales results; staff are not involved in non-selling activities; continuing relationships with customers are relatively unimportant
Additional non-cash rewards	Incentives, prizes, cars, recognition, opportunities to grow	Utilize powerful non-financial motivators	May be difficult to administer; do not provide a direct incentive	When it is believed that other methods of payment need to be enhanced by providing additional motivators

### Payment-by-result schemes

Payment-by-result (PBR) schemes provide incentives to workers by relating their pay or, more usually, part of their pay to the number of items they produce or the time taken to do a certain amount of work. The main types of PBR or incentive schemes for individuals are piece work, work measured schemes, measured day work and performance-related pay. Team bonus schemes are an alternative to individual PBR and plant-wide schemes can produce bonuses that are paid instead of individual or team bonuses, or in addition to them. Each of these methods is described in Table 42.3 together with an assessment of their advantages and disadvantages for employers and employees, and when they are appropriate.

**Table 42.3** Comparison of shopfloor payment-by-result schemes

Select	Main features	For employers		For employees		When appropriate
		Advantages	Disadvantages	Advantages	Disadvantages	
Piece work	Bonus directly related to output.	Direct motivation; simple, easy and to operate.	Lose control over output; quality problems.	Predict and control earnings in the short-term; regulate pace of work themselves.	More difficult to predict and control earnings in the longer-term; work may be stressful and produce RSI.	Fairly limited application to work involving unit production controlled by the person eg agriculture, garment manufacture.
Work-measured schemes	Work measurement used to determine standard output levels over a period or standard times for job/tasks; bonus based by reference to performance ratings compared	Provides what appears to be a 'scientific' method of relating reward to performance; can produce significant increases in productivity, at least in the short-term.	Schemes are expensive, time-consuming and difficult to run and can too easily degenerate and cause wage drift because of loose rates.	Appear to provide a more objective method of relating pay to performance; employees can be involved in the rating process to ensure fairness.	Ratings are still prone to subjective judgement and earnings can fluctuate because of changes in work requirements outside the control of employees.	For short-cycle repetitive work where changes in the work mix or design changes are infrequent, down time is restricted, and manage-

*continued*

Table 42.3 *continued*

Select	Main features	For employers		For employees		When appropriate
		Advantages	Disadvantages	Advantages	Disadvantages	
	with actual performance or time saved.					ment and supervision are capable of managing and maintaining the scheme.
Measured day work	Pay fixed at a high rate on the understanding that a high level of performance against work-measured standards will be maintained.	Employees are under an obligation to work at the specified level of performance.	Performance targets can become easily attained norms and may be difficult to change.	High predictable earnings are provided.	No opportunities for individuals to be rewarded in line with their own efforts.	Everyone must be totally committed to making it work; high standards of work measurement are essential; good control systems to identify shortfalls on targets.
Performance related pay	Payments on top of base rates are made related to individual assessments of performance.	Reward individual contribution without resource to work measurement; relevant in high technology manufacturing.	Measuring performance can be difficult; no direct incentive provided.	Opportunity to be rewarded for own efforts without having to submit to a pressured PBR system.	Assessment informing performance pay decisions may be biased, inconsistent or unsupported by evidence.	As part of a reward harmonization (shop floor and staff) programme; as an alternative to work measured schemes or an enhancement of a high day rate system.

*continued*

**Table 42.3** *continued*

Select	Main features	For employers		For employees		When appropriate
		Advantages	Disadvantages	Advantages	Disadvantages	
Group or team basis	Groups or teams are paid bonuses on the basis of their performance as indicated by work measurement ratings or the achievement of targets.	Encourage team cooperation and effort; not too individualized.	Direct incentive may be limited; depends on good work measurement or the availability of clear group output or productivity targets.	Bonuses can be related clearly to the joint efforts of the group; fluctuations in earnings minimized.	Depend on effective work measurement, which is not always available; individual effort and contribution not recognized.	When team working is important and team efforts can be accurately measured and assessed; as an alternative to individual PBR if this is not effective.