

# Managing reward systems

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Managing reward systems is a complex and demanding business. This chapter deals with the subject in seven parts:

1. Preparation and use of forecasts and budgets.
2. Evaluating the reward system.
3. Pay reviews.
4. Control.
5. Reward procedures.
6. Responsibility for reward management.
7. Communicating to employees.

## REWARD BUDGETS AND FORECASTS

Reward budgets and forecasts are concerned with overall payroll costs and the costs of general and individual pay increases.

### *Payroll budgets*

A payroll budget is a statement of the planned allocation and use of human resources required to meet the objectives of the organization. It is usually a major part of the

master budget. The budget is based on forecast levels of activity which determine the number of people required. The annual payroll budget is a product of the number of people to be employed and the rates at which they will be paid during the budget year. It will incorporate the cost of benefits (eg pensions contributions) and the employer's National Insurance contributions. The budget will be adjusted to take account of forecasts covering increases or decreases to employee numbers, the likely costs of general and individual pay reviews, changes to the pay structure and increases to the cost of employee benefits.

Managers in charge of budget centres will have their own payroll budget which they have to account for. This budget will incorporate forecasts of pay increases as well as the manager's assessment of the numbers of employees needed in different categories. Managers will be required to ensure that individual pay increases are made within that budget, which may, however, be flexed upwards or downwards if activity levels or the assumptions on which forecast pay increases were based change.

### *Review budgets*

A general review budget simply incorporates the forecast costs of any across-the-board pay increases that may be granted or negotiated during the budget year. Individual performance review budgets may be expressed as the percentage increase to the payroll that can be allowed for performance, skill-based or competence-related increases. The size of the budget will be affected by the following considerations:

- the amount the organization believes it can afford to pay on the basis of budgeted revenue, profit, and payroll costs;
- the organization's policies on pay progression – the size and range of increases;
- any allowances that may need to be made for increasing individual rates of pay to remove anomalies, for example after a job evaluation exercise.

The basic budget would be set for the organization as a whole but, within that figure, departmental budgets could be flexed to reflect different needs and circumstances. Pay modelling techniques which cost alternative pay review proposals on distributions of awards can be used to prepare individual review budgets. Increasingly, organizations are replacing individual review budgets with a total payroll budgeting approach. This means that departmental heads have to fund individual increases from their payroll budget. In effect, they are expected to add value from performance pay or at least ensure that it is self-financing.

## EVALUATING THE REWARD SYSTEM

The reward system should be audited regularly to assess its effectiveness, the extent to which it is adding value and its relevance to the present and future needs of the organization. This audit should include an assessment of opinions about the reward system by its key users and those who are affected by it. This leads to a diagnosis of strengths and weaknesses and an assessment of what needs to be done and why.

The operation of the reward system should be monitored continually by the HR department through such audits and by the use of compa-ratios and attrition analysis as discussed below. In particular it is necessary to analyse data on upgradings, the effectiveness with which performance management processes are functioning and the amount paid out on pay-for-performance schemes and the impact they are making on results.

Internal relativities should also be monitored by carrying out periodic studies of the differentials that exist vertically within departments or between categories of employees. The studies should examine the differentials built into the pay structure and also analyse the differences between the average rates of pay at different levels. If it is revealed that because of changes in roles or the impact of pay reviews differentials no longer properly reflect increases in job values and/or are no longer 'felt fair', then further investigations to establish the reasons for this situation can be conducted and, if necessary, corrective action taken.

External relativities should be monitored by tracking movements in market rates by studying published data and conducting pay surveys as described in Chapter 42.

No reward innovations should take place unless a cost-benefit analysis has forecast that they will add value. The audit and monitoring processes should establish the extent to which the predicted benefits have been obtained and check on the costs against the forecast.

### *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 to market rates in accordance with the organization's market stance policy.

Compa-ratios are used to define where an individual is placed in a pay range. The analysis of compa-ratios indicates what action might 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 process is sometimes called 'midpoint management'.

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 and policy pay are the same. Compa-ratios which 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 and 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 be attained 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.

## CONDUCTING PAY REVIEWS

Pay reviews are general or 'across-the-board' reviews in response to movements in the cost of living or market rates or following pay negotiations with trade unions, or 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. And they will 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 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 are:

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 the contingent pay

awards made by respondents to the CIPD 2003 performance management survey (Armstrong and Baron, 2004) 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 2003/4 performance management survey used ratings to inform contingent pay decisions. Approaches to rating were discussed in Chapter 33.

There may be a direct link between the rating and the pay increase, for example:

Rating	% Increase
A	6
B	4
C	3
D	2
E	0

Alternatively, a pay matrix may be used which relates pay increases to both the rating and position in the pay range. 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 2003/4 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.

### **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 2003/4 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 £21,000 rather than £20,000. The increase is 5 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. But ranking depends on what could be invidious comparisons and only works when there are a number of people in similar jobs to be ranked.

## **Guidelines to 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. For example, 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 but, only 8 per cent of the respondents to the 2003/4 CIPD survey used this method.

To help them to explore alternatives, managers may be provided with a spreadsheet facility in which the spreadsheets contain 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 relative to the policy guidelines.

### **Conducting individual pay reviews**

The steps required to conduct an individual pay review are:

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.

## **CONTROL**

Control over the implementation of pay policies generally and payroll costs in particular will be easier if it is based on:

- a clearly defined and understood pay structure;
- specific pay review guidelines and budgets;
- defined procedures for grading jobs and fixing rates of pay;
- clear statements of the degree of authority managers have at each level to decide on rates of pay and increases;
- an HR function which is capable of monitoring the implementation of pay policies and providing the information and guidance managers require and has the authority and resources (including computer software) to do so;
- a systematic process for monitoring the implementation of pay policies and costs against budgets.



## REWARD PROCEDURES

Reward management procedures are required to achieve and monitor the implementation of reward management policies. They deal with methods of fixing pay on appointment or promotion and dealing with anomalies. They will also refer to methods of appealing against grading or pay decisions, usually through the organization's normal appeals procedure.

### *Procedures for grading jobs*

The procedures for grading new jobs or re-grading existing ones should lay down that grading or re-grading can only take place after a proper job evaluation study. It is necessary to take action to control grade drift (unjustified upgradings) by insisting that this procedure is followed. Pressures to upgrade because of market forces or difficulties in recruitment or retention should be resisted. These problems should be addressed by such methods as market premiums or creating special market groups of jobs.

### *Fixing rates of pay on appointment*

Line managers should have a major say in pay offers and some freedom to negotiate when necessary, but they should be required to take account of relevant pay policy guidelines which should set out the circumstances in which pay offers above the minimum of the range can be made. It is customary to allow a reasonable degree of freedom to make offers up to a certain point, eg the 90 per cent level in an 80 to 120 per cent pay range. Pay policies frequently allow offers to be made up to the midpoint or reference point depending on the extent to which the recruit has the necessary experience, skills and competences. Offers above the midpoint should be exceptional because they would leave relatively little room for expansion. Such offers will sometimes be made because of market pressures, but they need to be very carefully considered because of the inevitability of grade drift unless the individual is promoted fairly soon. If the current rates are too low to attract good candidates, it may be necessary to reconsider the scales or to agree on special market rate premiums. To keep the latter under control, it is advisable to require that they should only be awarded if they are authorized by the personnel department or a more senior manager. Many organizations require that all offers should be vetted and approved by a member of the personnel function and/or a higher authority.

### *Promotion increases*

Promotion increases should be meaningful, say 10 per cent or more. They should not normally take the promoted employee above the midpoint or reference point in the pay range for his or her new job so that there is adequate scope for performance-related increases. One good reason for having reasonably wide differentials is to provide space for promotions.

### *Dealing with anomalies*

Within any pay structure, however carefully monitored and maintained, anomalies will occur and they need to be addressed during a pay review. Correction of anomalies will require higher level increases for those who are under-paid relative to their performance and time in the job, and lower levels of increase for those who are correspondingly over-paid. It is worth noting that over-payment anomalies cannot be corrected in fixed incremental structures, and this is a major disadvantage of such systems. The cost of anomaly correction should not be huge in normal circumstances if at every review managers are encouraged to 'fine tune' their pay recommendations as suggested earlier.

In a severely anomalous situation, which may be found at the implementation stage of a new structure or at a major review, a longer-term correction programme may be necessary either to mitigate the demotivating effects of reducing relative rates of pay or to spread costs over a number of years.

As well as individual anomaly correction there may be a need to correct a historical tendency to over-pay or under-pay whole departments, divisions or functions by applying higher or lower levels of increases over a period of time. This would involve adjustments to pay review budgets and guidelines and, obviously, it would have to be handled with great care.

## RESPONSIBILITY FOR REWARD

The trend is to devolve more responsibility for pay decisions to line managers, especially those concerned with individual pay reviews. But there are obvious dangers. These include inconsistency between managers' decisions, favouritism, prejudice (gender or racial) and illogical distributions of rewards. Research has shown that many managers tend not to differentiate between the performance of individual members of their staff. Ratings can be compressed, with most people clustered around the midpoint and very few staff rated as good or poor performers.

Devolving more authority to line managers may in principle be highly desirable but managers must be briefed thoroughly on their responsibilities, the organization's pay policies (including methods of progressing pay), the principles to be followed in conducting review and how they should interpret and apply pay review guidelines. The need to achieve equity and a reasonable degree of consistency across the organization should be emphasized. Managers should be given whatever training, guidance and help they need to ensure that they are capable of exercising their discretionary powers wisely. This training should cover:

- how information on market rates supplied by the personnel department should be interpreted and used;
- how data provided by the personnel department on the levels of pay and pay progression histories of individual members of staff and the distribution of pay by occupation throughout the department should be used as the basis for planning pay;
- methods of assessing performance and contribution levels;
- how to interpret any generic competence profiles to assess individual development needs and agree career pathways;
- how to assess competence requirements for specific roles (as they exist now or as they may develop), and how to counsel employees on the preparation of personal development plans;
- methods of reviewing progress in achieving these plans and in career development, and how to interpret information from these reviews when making pay decisions;
- generally, how to distribute rewards within budgets, fairly, equitably and consistently by reference to assessments of contribution, competence, progress or growth.
- the guidance available from the personnel function on how to manage pay – it should be emphasized that guidance must always be sought if line managers have any doubts as to how they should exercise their discretion.

Full devolution implies that the decisions of managers on pay increases are not reviewed and questioned as long as they keep within their budgets. However, it is usual for senior managers, personnel or pay specialists to monitor pay proposals to spot inconsistencies or what appear to be illogical recommendations, especially when the scheme is initiated or with newly appointed managers. The use of computerized personnel information systems makes it easier for managers to communicate their proposals and for the personnel department to monitor them. If the personnel department is involved, it should aim to provide support and guidance, not to act as a police

force. Monitoring can be relaxed as managers prove that they are capable of making good pay decisions.

## COMMUNICATING TO EMPLOYEES

Employee reward systems communicate messages to employees about the beliefs of the organization on what is felt to be important when valuing people in their roles. They deliver two messages: this is how we value your contribution; this is what we are paying for. It is therefore important to communicate to employees collectively about the reward policies and practices of the organization and individually about how those policies affect them – now and in the future. Transparency is essential.

### *What to communicate to employees generally*

Employees generally should understand:

- the *reward policies* of the organization in setting pay levels, providing benefits and progressing pay;
- the *pay structure* – grades and pay ranges and how the structure is managed;
- the *benefits structure* – the range of benefits provided, with details of the pension scheme and other major benefits;
- *methods of grading and regrading jobs* – the job evaluation scheme and how it operates;
- *pay progression* – how pay progresses within the pay structure and how pay decisions affecting employees collectively and individually are made;
- *pay-for-performance schemes* – how individual, team and organization-wide schemes work and how employees can benefit from them;
- *pay for skill or competence* – how any skill-based or competence-based schemes work, the aims of the organization in using such schemes, and how employees can benefit from them;
- *performance management* – how performance management processes operate and the parts played by managers and employees;
- *reward developments and initiatives* – details of any changes to the reward system, the reasons for such changes, and how employees will be affected by them – the importance of doing this thoroughly cannot be over-emphasized.

### *What to communicate to individual employees*

Individual employees should know and understand:

- their *job grade* and how it has been determined;
- the basis upon which their *present rate* of pay has been determined;
- the *pay opportunities* available to them – the scope in their grade for pay progression, the basis upon which their pay will be linked to their performance and the acquisition and effective use of skills and competences as their career develops, and what actions and behaviour are expected of them if their pay is to progress;
- *performance management* – how their performance will be reviewed and the part they play in agreeing objectives and formulating personal development and performance improvement plans;
- *the value of the employee benefits they receive* – the level of total remuneration provided for individuals by the organization, including the values of such benefits as pension and sick pay schemes;
- *appeals and grievances* – how they can appeal against grading and pay decisions or take up a grievance on any aspect of their remuneration.