Compensation Budgets and Administration

4BE3

Week 10

Learning Outcomes

- ❑ Explain the three components of labour cost and how they are mathematically combined to create total labour cost.

- ❑ Describe how salary level can be controlled by a top-down approach and a bottom-up approach.

- ❑ Identify five inherent controls in compensation design techniques.

- ❑ Define the six stages in the compensation communication cycle.

- ❑ Identify the various issues regarding how organizations structure the compensation function.

Managing Labor Costs

The cost implications of actions is critical for making sound decisions

❑ Compensation budgets require tradeoffs,
- ❑ employee contributions versus across-the-board
- ❑ short- versus long-term incentives
- ❑ performance versus seniority
- ❑ cash compensation compared to benefits

❑ Planning allows potential returns to be identified

EXHIBIT 13.1   Managing Labour Costs

Labour costs = Number of employees and hours worked × (average cash compensation + average benefit cost)
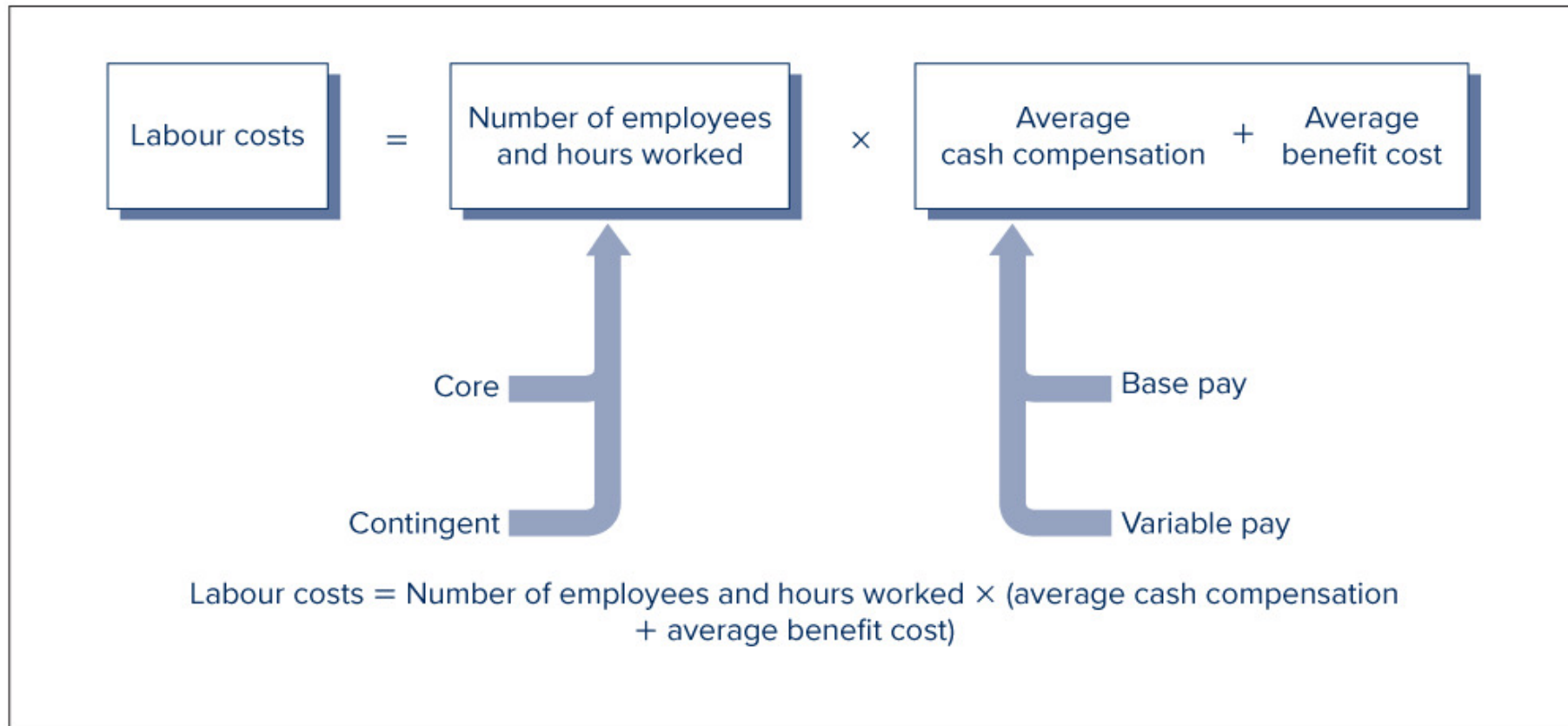
Managing Labor Costs

❑ controlling employment: number of employees and hours

❑ controlling average cash compensation costs

Reducing Headcount

Organizations reduce headcount through layoffs or exit incentives.

❑ Reduces benefit costs.

❑ Opportunity to reshape the workforce.

❑ However, regulations make cuts difficult.

❑ May harm employee relations, increase turnover.

❑ Increases unemployment insurance tax rates and administrative costs and disrupts workflow.

❑ May harm future business if cut too deep.

Managing Hours

- Firms examine overtime hours versus hiring more employees

- The four factors in the labor cost model are not independent.
    - Number of employees
    - Hours worked
    - Cash compensation
    - Benefit costs

- Reducing benefits costs includes:
    - Plan changes
    - Controlling health care benefits

Budget Controls: Top Down

- ❑ Top management sets an estimated pay increase budget for the whole organization.

- ❑ A typical approach is planned pay-level rise,
    - ❑ the percentage increase in average pay.
    - ❑ factors influencing size of increase:
        - ❑ current year's rise
        - ❑ ability to pay
        - ❑ competitive market rates
        - ❑ turnover effects, and
        - ❑ cost of living

Controlling Salary Costs: Bottom Up

EXHIBIT 13.3   Compensation Forecasting and Budgeting Cycle
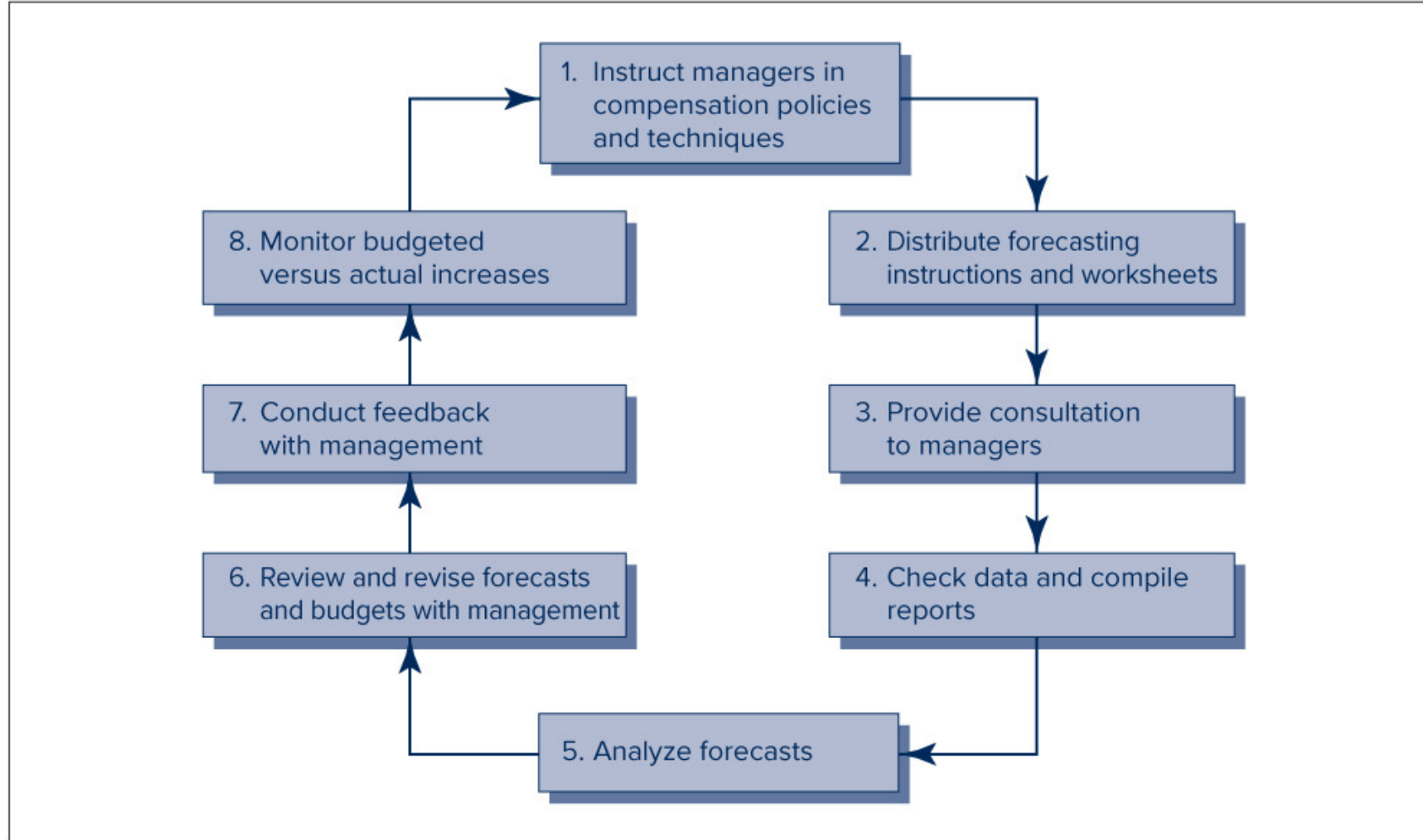
Embedded Controls

Controls on managers' pay decisions come from those inherent in the design of the compensation system:

- ❏ Range maximums and minimums
- ❏ Broad bands
- ❏ Compa-ratios
- ❏ Variable pay
- ❏ Analyzing costs
- ❏ Analyzing value added

Embedded Controls

- ❏ Range maximums and minimums
  - ❏ The maximum is an important cost control
    - ❏ Pay above the maximum is called red circle rates.
    - ❏ Pay below the minimum is called green circle rates.
- ❏ Broad bands offer managers flexibility
  - ❏ Bands may be more about career management than pay decisions.
- ❏ Range midpoints reflect the pay policy line in relation to external competition.
  - ❏ To assess how pay relates to the midpoint, an index called a compa-ratio is often used
  - ❏ Compa-ratio = actual rate paid divided by the range midpoint

Embedded Controls

❑ Variable pay must be re-earned each period.

    ❑ The financial insecurity may affect employees.

❑ Costing out wage proposals is done prior to recommending pay increases.

❑ Compensation drives future revenues.

❑ Companies analyze the value added of pay decisions and influence on revenues.

    ❑ Requires a shift in viewing compensation as an investment as well as an expense

❑ Employers must keep compensation current and competitive.

    ❑ To retain high performing employees

Managing Pay to Support Strategy and Change

❑ Successful alignment drives future revenues

❑ Strategic business changes mean the compensation strategy must be realigned

❑ Pay changes can play two roles in restructuring:

    ❑ Can be a leading catalyst for change, or

    ❑ A follower of change.

Communication: Managing the Message

❑ Compensation communicates what is important and what is not.

❑ Employees must understand the pay system.
- ❑ Understanding is shaped indirectly by paycheck.
- ❑ Shaped directly through formal communication.

❑ Two reasons for communicating pay information:
- ❑ Attract, retain, and motivate performance.
- ❑ Employees misperceive the pay system.
  - ❑ Especially helpful for benefit information.

Communication: Managing the Message

Step 1   Define the objectives of the communication program.

Step 2   Collect information from executives, managers, and employees to assess current perceptions, attitudes and understanding.

Step 3   Design a communication program that will convey the information needed to accomplish the original objectives.

- ❑ A marketing approach includes surveys, advertising, and websites.
- ❑ A communication approach focuses on explaining how pay is determined.

Steps 4 & 5   Determine the most effective media for the campaign.

Step 6   Evaluation of the campaign.

Structuring the Compensation Function and Its Roles

❑ The organizational arrangements of the compensation function vary widely
  ❑ decentralized – business units design and administer their own system.
  ❑ centralized – headquarters designs and administers the compensation system.

❑ Flexibility within corporate-wide principles

❑ Reengineering and outsourcing

Structuring the Compensation Function

Controlling decentralization problems

❏ Develop corporate-wide guidelines

   ❏ May differ for each major pay technique

❏ Outsourcing is a viable alternative

   ❏ May save money and increase quality

   ❏ May lose responsiveness to problems, have less control over decisions critical to all employees, and risk information leaked to competitors

Summary

❑ The key components of labour cost are number of employees and the hours they worked, average cash compensation, and average benefit cost.

❑ Salary levels can be controlled by a top-down budgeting approach by requiring top management of each unit to estimate the pay increase budget for the entire unit, and then allocating it to each manager, who plans how to distribute it among subordinates. The bottom-up budgeting approach requires each manager to forecast the pay increases he or she will recommend during the upcoming plan year, which are then reviewed by top management for approval.

❑ Inherent controls on pay decision making in compensation design techniques are range maximums and minimums, broad bands, compa-ratios, variable pay, and analyzing costs.

Summary (cont'd)

❑ The stages in the compensation communication cycle are define the objectives of the communication program, collect information on how the compensation system is perceived/understood, develop the best overall communication approach, determine the media and tools that are most appropriate, conduct the communication sessions, and evaluate the success of the program.

❑ Various issues regarding how organizations structure their compensation function include decisions on centralization versus decentralization of compensation management, level of flexibility for compensation management decisions within corporate-wide principles for all systems, and consideration of re-engineering or outsourcing the compensation function.