PART I

THE FUNDAMENTALS OF REWARD MANAGEMENT

Reward and reward strategy

01

The first part of this book is about reward strategy. I try to demystify it and give examples of what reward strategy is, and perhaps more important, explain what I mean by taking a strategic position on reward. It is all about maximizing value from reward through ensuring it aligns with the business (or organizational) strategy. This is real, practical and firmly organizationally focused.

In this first chapter I define what I mean by reward and reward strategy along with some associated terms and ideas. To start us off I need to deal with a few terms so you can see how I am using them in the rest of the book:

Reward

Definitions

- **Reward –** which is what this book is about. I will use the word to mean the total of all of the financially valuable related elements received by employees in an organization.
- **Remuneration –** means the same as 'reward'. It is commonly used in the context of the 'Remuneration Committee', which oversees the remuneration of senior executives and sometimes remuneration policy.
- **Compensation –** this is commonly used in the US and refers to pay and bonus. In larger US organizations, the two functions of compensation and benefits (referring to pension and healthcare in the US) are often separated.
- **Benefits –** are the non-cash parts of reward that are provided by the employer either to all employees or differentiated by level.

'Remuneration' and 'Reward' are interchangeable whilst 'Compensation' and 'Benefits' are a part of reward or remuneration. I have sometimes seen a job title such as Reward and Remuneration Manager, which makes no sense as it is a tautology.

- **Total Reward –** has started to be used to mean both reward plus a range of other non-reward items such as training and development. I do not think that this is helpful. My preference is to use 'Reward' or 'Total Reward' interchangeably and use a quite different phrase to capture the other things that in total make up the employee experience, such as the 'employee deal'.
- **Recognition –** is also sometimes used as in 'Reward and Recognition'. As I show in Chapter 9, recognition is very different from reward.

If you do want to take a broader definition of total reward then this may be helpful. Vartiainen *et al* (2008) suggest that rewards are all of the monetary, non-monetary and psychological payments that an organization provides for its employees in exchange for the work they perform. They go on to define reward as an outcome one receives from others for doing one's job, and they see three types of reward:

- Financial rewards – are all the monetary payments an employee receives. Financial rewards derive their motivating potential from their exchange function: money can be exchanged for desirable outcomes, eg goods and services.
- Material rewards – have an indirect identifiable monetary value, implying a cost for the organization although the employee cannot exchange the reward for its monetary value, eg training opportunities and presents.
- Psychological rewards – are the supportive and positively evaluated outcomes of the professional interpersonal relationships an employee develops with their supervisor, colleagues and/or clients eg compliments and recognition.

Elements of reward

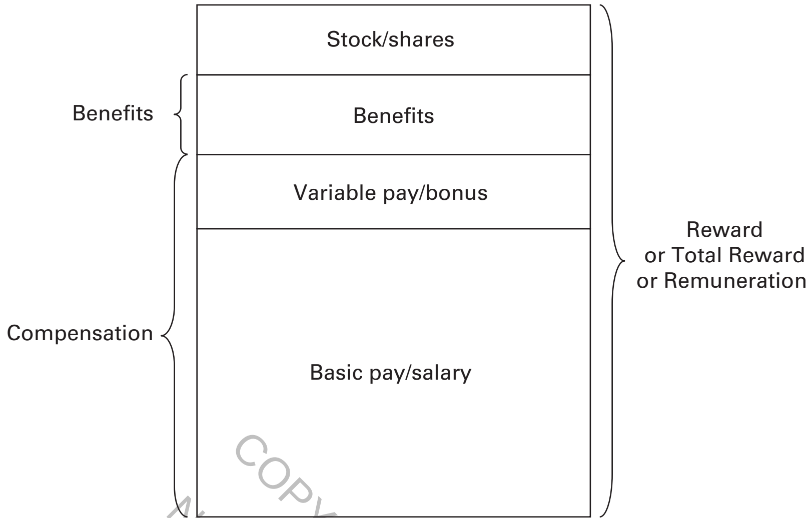
Reward can be broken into the four parts illustrated in Figure 1.1, which should also help explain the relationships between the terms discussed above.

Figure 1.1 implies the relative size of the four components, but of course this will vary considerably by corporate structure, sector, employee group and reward strategy.

Basic pay/salary

Basic pay (also referred to as base pay) is the contractual salary and may include allowances that are paid regularly and are, in effect, salary. Basic pay is dealt

FIGURE 1.1 The four components of reward



with in Chapters 8 and 9. For the vast majority of people, basic pay will always be the largest part of their reward. The two main exceptions are:

- senior executives whose reward may incorporate a large potential annual bonus and very significant share plans; and
- sales people or traders whose bonus and commission potential may be much greater than their salary.

Variable pay/bonus

Variable pay can come in many shapes and sizes, but mostly means some form of bonus. Unlike salary which is a fixed cost, variable pay is just that, variable – its payment will be contingent on something and so it may or may not be paid. If it is fixed, like a guaranteed bonus, I would consider this is the same as salary just dressed up as something else by using a different name. Bonus is discussed in Chapter 10.

Benefits

Benefits are not cash and will include tangible things like company cars, insured benefits like life assurance or medical insurance, pensions and some terms and conditions such as holidays. Whilst I have classified shares as a separate element of reward, primarily because for executives their value can be very large, they may be considered part of the benefit package. The range of benefits (covered in Chapter 13) will vary between sectors and, often, by seniority. Interestingly, the proportion of cost devoted to benefits can be highest in the UK public sector due to the pension arrangements. In public sector defined benefit (DB) pension plans still dominate whilst they are now extremely rare in the private sector where some form of defined contribution (DC) plan is more common. The cost of a DB pension plan is normally very considerably higher than a DC plan.

Stock/shares

Share plans, by definition, will only be available within private sector companies with shares. Shares are mostly available for the more senior employees, but some companies have 'all employee share' plans that allow everyone in the business to become a shareholder, usually by buying shares within a tax approved plan. The types of share plan will vary considerably and are heavily dependent on the relevant tax legislation. Shares are dealt with in Chapter 12.

The whole should be greater than the sum of the parts

Effective reward management is about both the individual elements of reward and the total cost and value. The different parts of reward may be for different purposes but they all cost money to provide, so the organization needs to look at the total as well as the separate elements. There will be some choices about where to spend the organization's money to best effect in the balance between the different parts of reward. For example, fixed basic pay could be lower but with a high potential bonus or profit share. Or more could be spent on tax-efficient benefits that deliver good value to employees than fully taxable salary.

What is important is that the options and the impact of these choices are considered carefully taking a strategic approach and the rationale is clearly explained to employees. It was common in the past, and persists in many organizations today, that the different elements of reward were managed separately and sometimes in a piecemeal fashion. For example, cars were managed by fleet management, pensions by the pension's department and so on. Whilst this might have been administratively efficient, overlooking the total value proposition to employees would lose the value to the organization of their total spend on reward. I discuss how this can be helped by effective communications in Chapter 6.

Cost of reward

It is a surprise to some organizations quite how much they spend on the total cost of reward and in particular the proportional cost of the various elements. For example, I have worked with an organization where the cost of the DB pension for just 15 per cent of their employees cost half of the total amount spent on all benefits for the whole company. As you might expect, they did something about this inequitable spend.

A valuable way of considering the total cost of reward is as a proportion of all of the costs of an organization (property, technology, power, insurance, interest etc). Reward can be anything from 5 per cent to 75 per cent of total costs. At one end there is the service sector which has little capital employed and where reward is likely to be more than 70 per cent of total costs. At the other extreme, in a sector such as oil and gas, which uses a huge amount of capital, the total cost of reward can be less than 5 per cent of all costs. Whilst employment costs will be of interest to all finance directors and leaders of organizations, where it is by far the most significant cost, it should be given particular attention.

I believe that it can be very helpful to show the total costs of reward as a percentage of the total costs of the organization plus the costs of the different categories of reward. You can illustrate these for your own organization as pie charts. This information can attract the attention of key stakeholders, who may never before have considered reward in these terms. It can lead to questions and valuable discussion on the role of reward in the organization.

Reward strategy

Definition

Valuable insights can come from unexpected sources. For example, in *Alice's Adventures in Wonderland* by Lewis Carroll, Alice asks the Cheshire cat which way she ought to go. But when asked where she wants to get to, Alice says that she doesn't care much. In which case, says the cat, 'Then it doesn't matter which way you go.'

The point for us is pretty obvious. We need to have a sense of direction to enable us to develop reward strategies that are relevant, meaningful and will help the organization. A sense of direction also helps us filter the opportunities that we come across which are likely to support or hinder our progress.

Armstrong and Murlis (2004) note the importance of direction as an element in a reward strategy: 'Reward strategy determines the **direction** in which reward management innovations and developments should go to **support the business strategy**, how they should be **integrated**, the **priority** that should be given to initiatives and the **pace** at which they should be implemented'.

Duncan Brown (2001) says that '... reward strategy is ultimately a way of thinking that you can apply to any reward issue arising in your organization, to see how you can create value from it'.

Three other unattributed definitions of reward strategy I have come across are:

- 'The incorporation of business issues into decisions on reward policies'.
- 'An integrating approach, linking company strategy, employee behaviours and outcomes'.
- 'A means of ensuring that reward systems actively help businesses to go where they need to'.

The shorthand definition of reward strategy that I use is:

> Reward strategy is an approach to reward based on a set of coherent principles in support of the organization's aims.

A fundamental element of reward strategy reflected in all of these definitions is to support the organization. That is not to say that reward strategy should be only reactive. But the approach taken needs to reflect the culture and aims of the organization. In some cases it can help to drive change. Certainly as part of the HR strategy getting reward 'right' can help deliver solutions that help drive strategy. But you do need to understand the aims and values of the business. A survey of business leaders concluded '... HR must develop a deep understanding of the business – in the same way, and using the same 'language', as other managers. The measures it proposes must be tied to business outcomes: the impact on customer service, the reduction in costs, the support of a specific new growth area, the increase in staff loyalty and so on.' (KPMG, 2012)

Armstrong and Murlis (2004) say that reward strategy

> '... clarifies what the organization wants to do in the longer term to develop and implement reward policies, practices and processes that will further the achievement of its business goals. It is a declaration of intent, which establishes priorities for developing and acting on reward plans that can be aligned to business and HR strategies and to the needs of people in the organization.'

Based on the examples in this part of the book, you can define what reward strategy means for your own organization. But whatever definition you decide on, it is important to see reward strategy squarely in the context of the organization's business strategy and HR strategy.

Prevalence

It is perhaps surprising that few organizations have a reward strategy. This reflects my experience of the lack of a strategic approach to reward. According to the CIPD 2010 Reward Management survey (the last year they collected this data), only 35 per cent of participant organizations had a written reward strategy.

Best fit

There is a paradox in that product development, marketing and sales are greeted with plaudits when coming up with a new product, process or approach to market. It is the new that can beat the competitors in this fast-changing world. But when HR come up with a new idea it can often be greeted with the question, 'What do our competitors do?' This reaction, of course, does not acknowledge the uniqueness of the particular organization's culture.

Whilst we must reward people to ensure that we can compete effectively in the appropriate employment markets, the way we do so should reflect our particular organization. It is the culture and values that define the brand and reward should reflect these, not blindly follow the market. So I strongly advocate an approach of 'best fit' not 'best practice'. Not 'me tooism' but, 'What will work for us?' Whilst there will be some issues on legal compliance which need to be followed, in general 'best practice' is an invalid concept. Certainly look at what others are doing, but develop the reward strategy that is right for you, not some other larger organization down the road with a different history and culture.

A recent survey of World at Work members (Workspan, 2012) found that whilst two-thirds of respondents agreed or strongly agreed that 'Our compensation function is focused on creating unique/tailored compensation solutions for our business', 42 per cent said that there needed to be a greater focus on this for the future.

You should also guard against following the latest fad that seems to be doing the rounds. But rather, evaluate its fit for your organization based on evidence. This can be particularly sensitive when it is the chief executive who makes the suggestion as something they have come across that they think you should have in your organization.

Other terms

Reward strategy may be the overall approach you take, but there are other related terms that we should touch on. I do not think we need to agonize over which term means exactly what, rather use the terms in the way that works best for your organization. But I give here my suggestions on how the following terms may be used:

- **Reward Philosophy –** (also Reward Principles) the description of the beliefs of reward and how it should operate within the organization. It may be linked to the organization's values. It is overarching and is used to broadly frame the reward strategy. In Chapter 5 I discuss how you can develop this and give some examples.
- **Reward Framework –** the broad overview of the related and possibly interlinked elements of reward. May be diagrammatic to illustrate how the pieces of reward fit together.
- **Reward Policy –** the detailed policies on specific elements of reward which give the flexibility, discretion and limits. Typically, this will cover the main 'rules' about reward and may be part of the terms and conditions of employment.
- **Reward Procedure –** the detailed procedure and processes that explain what exactly has to be done by different people to enable an element of reward to change or be introduced, typically giving work flow of forms, authorization levels etc. For example, annual pay review process or absence procedure.

Timing

The nature of reward is that much of it runs on an annual cycle such as: financial year, annual pay review, annual bonus and annual renewal of insurance policies. This means that if you miss making a change at the right time in the cycle, you may have to wait another whole year. Often you need to take a long-term view and, based on the sense of direction, may need to make changes over two or three years. This is not just a practical issue, but may be needed to carry the key stakeholders with you.

Of course, whilst the strategy might move you neatly in a particular direction and at an ideal pace, both are likely to be influenced by internal and external factors (discussed in Chapter 4). These can and are likely to throw you off course. That is just the real world we live in. It must not, however, put you off developing a reward strategy. It is the reward strategy that will help you determine the best approach in light of the inevitable changes along the way.

It is the totality of what we do that is important and all of the elements of reward carry messages. But the strategy is made real by making things happen. So whilst the reward strategy should give you the direction and general approach, it is the aggregation of the things that are done that move the organization on.

How you make reward strategy come to life is a central theme of the rest of this book.

Summary

Whilst there are different terms used to define reward and reward strategy, you need to get this clear and consistent for your own organization. Whether you develop something you call a reward strategy, philosophy or framework, you should have what works best in your organization, provides some framework within which reward changes can be made and helps give a sense of direction.

Questions

- What terms will you use to describe reward?
- How will you establish your definition of reward strategy?
- Would it be of value to analyse the total costs of reward as a percentage of the organization's overall costs?
- Would it be helpful to see the cost of each category of reward?