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ANALYSIS OF OPTIMAL COMPENSATION BUDGET MANAGEMENT FACTORS

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***Abstract*—**Budgeting compensation costs is one of the most important issues of cost management as an important segment of the company's financial performance management. The total amount and structure of compensation costs significantly affect of the total cost behaviour and cash flow. But, at the same time, compensations for employees have a strong potential impact on employee satisfaction and motivation and work performances. Positioning of an average level of compensations in relation to competition, the introduction of incentive pay forms, structuring pay grades and other decisions related to employee compensations, has two aspects - cost and motivational, creating a complex impact on the overall business performances. Compensation budget, therefore, is nothing but art - the art of balancing between the two seemingly conflicting demands - to control costs and motivate employees through compensation. The purpose of the compensation budget optimization is to answer simultaneously to both these requests, reducing the degree of operating leverage and increasing the company's profit-making capacity.

***Keywords*—**cost management, employee motivation, work performances, business performances, compensation budget management.

I. Introduction

SALARIES are a significant component of total operating costs of each company. In labor-intensive industries, such as the service industry, by far the largest percentage of operating costs refers to salaries. As an important category of income statement and cash flow, salaries are in constant focus of a company's financial management. As operating business costs, they impact a company's financial performance in a direct and obvious way. However, salaries at the same time achieve an indirect positive impact on a company's business results and cash flow. Transmission mechanism of this influence of salaries is employee motivation. Although not the only and often not the most important motivators, material rewards for employees, which the compenastion system consists of, have a strong influence on employee satisfaction and their work motivation. Although indirectly, the impact on a company's performance should be stronger and more far-reaching and to significantly exceeds the compensation costs as the price of using knowledge and skills of professionals from different fields, as the carriers of a company's development. Because of that, the focus in the treatment of compenastion costs should move from observation them merely as operating costs to strategic investment in attracting, developing and retaining valuable, competent and dedicated professionals, the best representatives of different professions, without which a modern business enterprise has little chance to succeed.

From a series of strategic choices that affect the total amount and structure of compensation costs, those with the greatest motivating potential should be emphasized. In this regard, special attention belongs to issues of internal and external equity of the reward system, in which the pay grade policy plays a special role, then the issue of regular payments and maintaining of the real value of salaries and finally the possibility of introducing various forms of incentive pay. It is the incentives, as a variable, performance-based part of compensation package, that is a particularly important strategic management tool, which can affect simultaneously the behaviour of costs and income and cash flow, directing them towards the optimal business results.

II. Implications of the Compensation Budget Components Mamagement on Business Performances

In order to analyze their impact on the company's performancess, it is necessary to define the basic elements of the compensation budget. Looking at the employee compensation system in the broadest sense, that is, covering by that term not just the net income of employees, mandatory social insurance and income tax, but also all forms of benefits and conveniences for employees (including investment in employee professional development), we define three basic components of the compensation budget: the total number and structure of employees, the average gross salary (plus mandatory social security contributions paid by the employer) and the average cost of benefits and conveniences for employees. Each of these components of the compensation budget has its cost and motivational aspects, affecting the company's performances both ways.

Total number of employees, their qualification structure, and their disposition across the business functions in a company, must be in function of achieving the company's goals and maximizing overall business performances. For the defined average level of salaries, less employees means less compensation costs. However, there is always a lower limit of the number of employees for a certain level of business activity, below which the normal functioning of a company is endangered. Thereat, of course, it cannot be all the same what the qualification and organizational structure of employees is. That is, whether the reduction in the total number of employees of, for example, ten employees, refers to ten production workers with the lowest skill level or ten experienced technicians and engineers of different specialties or three officers and two managers in finance, two sales managers and three production workers, etc. Optimization of the number of employees results from the optimization of organizational structure, which has to fully support the strategic corporate objectives. In this sense, the proper analysis of the tasks performed in the company is very important, based on which the needed job positions are defined, along with the job content and manner of its performance (the required qualifications) for each position. The way different business functions in a company are organized and related is certainly an expression of management philosophy and unique style of leadership. But the universal rule in organizing a business enterprise is that an organization must not content "bottlenecks" or "hidden unemployment". Bottlenecks hamper a company's functioning, causing unnecessary costs due to loss of time and deadline non-compliance, negative impact on the quality of processes and products and, finally, customer dissatisfaction. Under-utilization of labor potential of employees (so-called hidden unemployment) daily generates unjustified compensation costs, which have a direct negative impact on the company's financial performance. As a rule, such a phenomenon has a negative effect on employee morale and quality of processes and products. Lack of involvement of one often means over-load of other employees, and reduce the quality of their work, with the decline in work motivation and causing employee frustration. Therefore, any decision to decrease or increase the number of employees, engage or discharge any individual, must be based on a comprehensive assessment of the impact of the decision on overall business performance, not only on financial performance in the short term. The role of human resource management is crucial in this process.

The level of average salary in a company is primarily affected by the profitability i.e. the company's earning power, average wage on the national level, adopted external employee compensation eqiuty strategy, as well as determination of whether to adjust salaries to the costs of living growth rate. The company's profitability depends on the internal efficiency and its position within the industry, but also on the average level of profitability of the industry itself. Companies from the high-tech industry are, as a rule, highly profitable, with very high growth rates, employing relatively small number of workers, mostly highly educated IT professionals. Because of that, they are able to offer them relatively high salaries. On the other hand, it is imperative for them, because the demand for such labor profiles still exceeds the supply. In traditional industries, especially the labor-intensive ones (textiles, for example), the matter is quite different. Low profitability and relatively high share of labor costs in total costs result in low average wages.

The general level of wages in the state also affects the level of average salary in a business enterprise. One of the main conditions for the arrival of foreign companies are relatively low wage costs in relation to the general level of qualification of the local labor force. The general level of wages in the state is affected by the strength of trade unions, but in the long run, this level is a reflection of the level of national economy's development.

Assuming that money is a major motivator, a company must determine how to define the the average salary level in regard to its competition. The goal is to attract and retain competent professionals with the key influence on the company's development. There are three basic strategies of external competitiveness of salaries - a strategy of leadership in wages, equal pay strategy and the strategy of lower wages. Typically, market leaders opt for a strategy of leadership in wages, offering the highest average salary for a specific profile of labor force, seeking to attract the best representatives of certain professions [3]. Most companies, however, chooses to offer the same salary as their competitors. The strategy of lower wages is an option for the companies that simply do not have a business and financial capacity to offer a competitive salary. Such firms can try to compensate that handicap by offering certain conveniences and benefits to its employees, and by greater use of non-material rewards as a means of employee motivation.

An important issue in determining the average salary level in a company is whether the basic pay should be adjusted to the cost of living growth rate or the dinar exchange rate against the euro (as, for example, common in banks and companies that make their income in this currency), that is whether to include effects of inflation / devaluation in the salary calculation. The research that author of the paper V. Zlatić conducted last year on a sample of 1260 employees (1060 executors and 200 managers) in 20 companies of various sizes, shows that most employees, regardless of position in the company and the type of work performed, consider maintaining the real salary value extremely important. For this result we can say that was expected, given the relatively high level of indebtedness of the population in commercial banks in foreign currencies and the relative correlation of inflation and devaluation of the dinar. On the other hand, for companies that realize their revenues exclusively in local currency and cannot significantly effect the market prices, the commitment to inclusion of inflation (or devaluation) in the salary calculation may have a significant nagative impact on overall financial performance.

The various benefits (other than mandatory social security) and conveniences for employees can be an important factor when deciding whther to change the employer or not. This applies also to the various training programs and employee development. Conveniences and benefits can compensate, in terms of motivation, the lower salaries comparing to the competition, but we should bear in mind that they also require expenses and that they increase the total compensation costs. In addition, a number of benefits and conveniences are common in most companies, while the value of certain forms of benefits has not yet been sufficiently socially recognized (additional pension and health insurance). In any case, this segment of the compensation budget may be an important motivational tool in the fight to attract and retain competent and diligent workers.

III. MOTIVATIONAL ASPECT OF PAY GRADE STRUCTURING

By defining pay grades, boundaries which compensations for employees, ranked in a certain pay grade, can move in are established. In this regard, pay grades are the instrument of automatic control of the compensation costs growth. The introduction of pay grades creates the possibility that employees which perform similar tasks and are grouped in one pay grade, are paid to somewhat higher or lower level than the average of that pay grade. That mechanism for "fine tuning" of salaries allows management to respond to pressures from external and internal environment and maintain the motivation of employees at the desired level. The criteria for the positioning of an employee's salary relative to average salary in the pay grade may be different. Their use, however, must always have the same goals - maintaining employee motivation and satisfaction at the required level, preventing unwanted employee turnover and constantly improving knowledge and skills of employees. Possibility of offering the salary whichis higher than the average of a certain pay grade can be crucial in hiring a quality professional, which is needed in the company. Also, by gradual salary increase within the pay grade, the experience and loyalty of employees can be rewarded, which can significantly affect their satisfaction and motivation to continue improving their performance and remain loyal to the company.

Projected compensation budget is based on projected average salaries in different pay grades, including all possible increases of salaries of individuals or teams, or all employees, based on the results (stimulation). Any planned increase or decrease of the compensation budget by a certain percentage means an increase or decrease in the average salary in that percentage, not that all salaries will be increased or reduced by the same percentage. The total projected compensation budget is distributed to organizational units according to the total number and the structure of employees in each organizational unit, i.e. according to the value of jobs in different organizational units. The managers of organizational units are responsible for the compensation budget allocation to employees, respecting the principles of the compensation system applied in the company and respecting the defined ranges of pay grades. Crossing the pay grade borders to achieve external competitiveness of salaries and attract and retain quality professionals, can undermine the internal equity of salaries, produce conflicts, reduce work motivation and have a negative impact on overall business performance. Since salaries are relatively inflexible downward, re-balance between the requirements for internal fairness and external competitiveness is established at a higher level of salary costs, i.e. increasing the level of average salary in a company. This, in turn, can adversely affect the financial results and cash flow of the company if salary growth is not accompanied by growth in sales and profit of the company, while keeping the indicators of efficiency and profitability at the same level or improving them.

The ranges of pay grades are typically lower at lower hierarchical levels, and greater at higher levels, with gradual expansion, from the lowest to the highest pay grade. The expansion follows the logic of growth of responsibility and authority to influence the company’s overall performance with the transition to higher levels in the organizational hierarchy. Greater range of higher pay scales should ensure a high level of motivation and commitment of top managers, whose decisions have significant impact on a company’s performance. On the other hand, the ranges of pay scales at lower hierarchical levels should not be too narrow, in order to make a clear distinction between those who have above-average operating performance and those whose performance is below average and stimulate the best peformers to further develop their skills and performance. A common framework for the range of pay scales for top managers is 60-120%, and for administrative and manufacturing operations 10-25% (the percentage of the minimum salary increase needed to obtain the maximum salary of the pay grade) [8]. As for the optimal number of pay grades, there is no universally applicable recipe. Number of pay scales depends on the size and organizational complexity of the company and can range from 4-5 to several dozen grades. The modern tendency is to reduce the total number i.e. to merge pay scales. However, such decisions must take into account the perception of such a policy by the employees and the impact on their motivation.

IV. VARIABLE PAY IN FUNCTION OF COST CONTROL

In addition to the base pay (with a possible increase in order to preserve purchasing power), which is guaranteed to employees by employment contract, regardless of their performance, various forms of variable pay can be introduced in the compensation system of a company. That is a variable part of the salary, which is based on performance i.e. depends on the performance (performance) of an individual, group (team) or the company as a whole. There are different forms of incentives for employees, depending on the type of work performed by employees and positions in the organizational hierarchy. The basis for the stimulation can be individual or group (team) performance and the performance of a company as a whole. Individual performances of managers are measured by the results of the organizational units they manage.

The most common types of incentives for employees are variable part of the salary (incentive program payment) and bonuses, while managers are stimulated by annual bonuses, as short-term incentives, and different forms of long-term incentives - shares, options etc. and certain exclusive rights (use of company car, company credit cards, club membership, etc.) [2]. There are several variants of variable pay calculation, depending on the type of work the employee performs (production, sales, etc.), but all are based on the setting of standards and measuring performance against those standards. One-time bonuses (prizes) are awarded for special achievements and results of employees which may not be covered by variable pay, and also for employee loyalty (jubilee). On the other hand, bonuses for managers are based on the performance of a company as a whole (top management) or the organizational units they manage. The aim of the long-term incentives implementation, such as the rights to shares and options, is to motivate top managers to increase the value of the company in the long run, in order to avoid that managers make decisions that are in the long run bad for business, for the sake of high annual bonuses.

Variable pay aside from its unquestionable great motivational potential, can represent a significant factor of operating cost control. Decomposing the total salary to a fixed (basic pay) and a variable part (based on performance) and reducing the level of total fixed costs allows management to reduce business risk and the factor of operating leverage for the defined sales volume. Compensation cost growth in situation when the revenue grows above the projected average level, will not decrease the rate of business profit, if the incentive pay system is built on the above principles. In case of bad scenarios and decline in business operations, salaries will also be reduced to the basic pay level, with a controlled impact on employee motivation. This reduction of the share of fixed costs in the total compensation costs have positive influence on financial leverage and stabilizing of the company's financial position. Figure 1 shows a comparative graphic presentation of the two alternative functions of revenue and expenses for a hypothetical trading company. The first function of income and expenses (UP, UT, VT, FT) shows the income and expenses when the salaries of sellers are divided into the fixed and the variable part, where the variable payment is calculated as a percentage of total realized margin, which the seller is entitled to only if her/his sales reach a certain volume. It is assumed that other employees are also stimulated via the variable pay (employees engaged in the procurement, storage, transport and other business activities), provided that the variable pay calculation is adjusted to the nature of their work. The second function of income and expenses (UP2, UT2, VT2, FT2) shows the income and expenses in the case of fixed salaries for all employees. It is evident that the turning point in the case of implementation of variable pay is at a lower level, with the broader field of profit. That means lower operating leverage for a given sales volume. Although highly simplified, the example is illustrative enough to show the way in which a system of variable pay may affect the behaviour of the total costs and revenues.

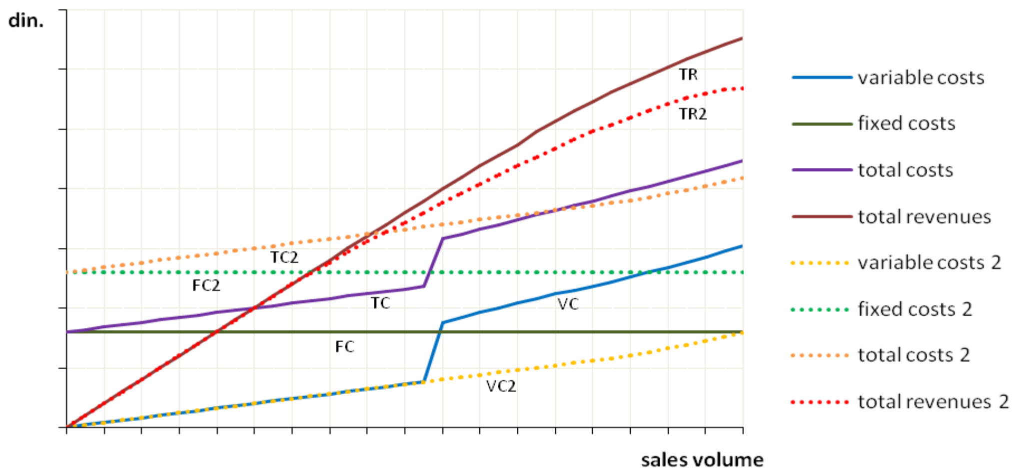

Fig. 1: Revenue and cost functions for two alternative compensation systems

V. COMPENSATION BUDGET OPTIMIZATION – FOCUS ON KEY PERFORMERS

Optimal compensation budget, beside the financial discipline and cost control, should provide sufficient space for the use of compensation plans in the motivational process. Compensation system, in this regard, should be structured so as to favor employees who earn above-average results and have the willingness to advance their competence and improve their job performance, at the same time pointing out the bottlenecks and hidden unemployment. This is achieved primarily by introducing the forms of variable pay.

For employees whose performance is relatively easily expressed quantitatively, it is possible to apply a system of incentives based on the individual or team performance. What basis will be applied depends on the nature of the work or the degree of individual autonomy of employees in performing their jobs. In order to make the performance evaluation realistic and objective and the introduction of variable pay justified from the point of employee motivation, it is necessary to eliminate or to accurately assess the impact of external factors on the employee (or team of employees) performance which the employee (or team of employees) has no control of. For administrative and other staff whose performance can not be quantified, it is possible to introduce the variable part of salary based on the results of the company or the organizational unit to which they belong. This part of administrative staff salaries, expressed as a percentage of the base pay, should not be greater than, say, 20%, so that it doesn't achieve the opposite effect and lead to employee frustration in the event of poor business results which they have practically no impact on. In addition, all employees should be allowed to make proposals concerning the possibility of improving business processes that are involved in, through a transparent and stimulating system of proposals evaluation and rewarding in form of a percentage of the estimated value of any savings or increased revenues based on the application of the proposed solutions. In this way, among administrative, accounting, financial and other general tasks performing staff also, those who use their knowledge, skills and commitment to add value to the company can be recognized and encouraged.

Lowering base pays to a somewhat lower level, by introducing a variable forms of pay must not, however, compromise the external competitiveness of salaries. The base pay is an important part of the total employee compensation, which gives an employee the sense of certainty, especially in terms of long-term borrowing from commercial banks (mortgage loans, for example) and is an important factor when deciding on the change of employer. Also, the maximum total compensation – base pay plus incentive - must not go beyond pay grade boundaries.

Bonding directly as possible the part of the total compensation cost to the business results, leaves more room for eventual implementation of the salaries real value maintaining policy as well as for investments in a variety of employee training programs. These programs can have long term positive effects, but the cost of implementing these programs can be a burden for a company's finance in the short term, in the situation of the decline of business activity.

A few more questions related to optimizing the compensation budget merit attention: engagement of employees on the temporary or the part-time job basis and outsourcing.

Hiring part-time workers for seasonal jobs, or because of occasional increase in the volume of certain business activities is related to the issue of optimizing the number and structure of employees. The same is true for jobs that are permanent in character, but for which it is uneconomical to provide new job positions, where employees would not be fully employed. This would needlessly waste limited funds, making constant negative impact on the company's financial performance. Hiring of specialized companies and agencies, which number is consantly growing in our economic practice, to perform such tasks, prove itself as a logical solution.

VI. Conclusion

Compensation budget projection is based on the optimization of the total number and structure of employees, defined level of the average salary (with the defined level of mandatory social security contributions and income tax), the employee rewarding policy and employee development strategy implemented through various training programs. Bearing in mind that the salary is very inelastic downward without drastic negative effects on the employee morale, compensation budget projection must have a medium-term character and fit into different business scenarios for the next several years.

The introduction of the forms of variable pay and other forms of employee incentives, related to the business results, is significant from the standpoint of employee motivation, but also from the aspect of the compensation budget optimization. It is the way to recognise the organization's key performers - those who move forward and increase the value of the company, reducing at the same time the pressure on operating results and cash flow that the compensation budget make.

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