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Compensations and their impact within SMEs

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Abstract

The small and medium-sized enterprises (SMEs) play a vital role in the economic structure in every country due to their significant contribution in terms of output, exports and employment. Today, along with large-scale corporations, SMEs have gained importance in the developing economies, since they experience the capability of quick adaptation, working with less capital but more intense labour and having lower costs of management and thus having cheaper production/service provisioning. SMEs are less affected from economic crisis due to their flexibility and abilities to keep up with rapidly changed market circumstances. They are vital actors for enhancing innovation, competitiveness, entrepreneurship and the establishment of an effective innovation system for developing countries. For a better positioning in the market and notable business results compensation policies are highly important for SMEs. Compensations and their impact within small and medium-sized enterprises are multiple. Accurately structured compensation policy is a key to the success both in the individual and organizational level. Implementation of well-defined compensation policies, i.e. material and non-material compensation, could equip a SME with higher employees satisfaction, better motivation and, accordingly, better business results which is the aim of every enterprise. This paper presents a general overview on compensation policies within SMEs and focuses on relation between compensations and business results.

Key words: *SMEs, Compensations, Compensation policy*

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1. INTRODUCTION

Small and medium-sized enterprises (SMEs) are seen as the main actors of both national and regional development in many countries. They always take significant roles in many industry branches. Therefore, SMEs as the driving force of economic growth have an important effect on the economic activity.

Well-designed compensation policy and employees satisfactions are important factor in the development of business performance in SMEs. The process of improving competencies of employees in SMEs affects the motivation, satisfaction and success at the individual level and the productivity and the best business results at the organizational level. Therefore, it would be useful to develop idea for forming a model of financial support to improve competencies of employees in small and medium-sized enterprises.

Compensations are divided into basic (wages/salaries) and additional. Salaries/wages represent material compensation for the work and their goal is to ensure and improve the material position of employees, while additional compensation can be material and non-material. Both additional material compensation (bonus

- usually in cash, benefits, shares and options) and additional non-material compensation (training, development programs, etc.) for the enterprises are considered as financial costs.

Enterprises must allocate significant funds to ensure material and non-material compensations, which represents the main problem today and they are usually not keen to accept that kind of cost. A model that helps SMEs to understand better the benefit of their spending on additional compensations will make acceptable financial investment which will ensure motivation and devotion of employees and demonstrate a good step for increasing profitability and productivity.

By creating such a model that could help many small and medium-sized enterprises to achieve the best results with a good organizational climate and atmosphere, it is possible to contribute to the development of compensation policy structure within SMEs.

Some of important variables to be considered in the future model can be:

1) Sector to which an enterprise belongs (e.g. sectors that contribute mostly to economy or GDP),
2) Management level of the enterprise representatives (top, middle, low level),
3) Timing of compensation (per year, per semester, quarterly),
4) The percentage or sum of the total fixed costs for salaries allocated for the compensation.

The processing of these data should help in forming an image, for example: an enterprise, which belongs to the IT sector, for a staff position at the middle level of management, allocated 5% out of total salaries costs for additional non-material compensation within the first and second quarter. After that, we analyse obtained results depending on the quarter, the sector where enterprise belongs and position (level) of the respondents.

The development process of this model could ensure for the enterprises an acceptable financial investment which will provide the motivation and devotion of employees, which ultimately should demonstrate the successful growth of the overall business results expressed through the total revenue.

2. SMEs

The term SMEs covers a wide range of definitions and measures, varying from country to country and between the sources reporting SMEs statistics. Some of the commonly used criteria are the number of employees, total net assets, sales and investment level. However, the most common definitional basis used is employment, and here again, there is variation in defining the upper and lower size limit of an SMEs. Despite this variance, a large number of sources define an SMEs to have a cut-off range of 0-250 employees. All our sources focus on SMEs in the manufacturing sector. SMEs are defined as formal enterprises and thus different from informal enterprises. [3]

SMEs form a large part of private sector in many developed and developing countries. While cross-country research sheds doubt on a causal link between SMEs and economic development, there is substantial evidence that small firms face larger growth constraints and have less access to formal sources of external finance, potentially explaining the lack of SMEs contribution to growth. Financial and institutional development helps alleviate SMEs growth constraints and increase their access to external finance and thus levels the playing field between firms of different sizes. [5]

By drawing upon the concept of competitiveness and the competency approach, a conceptual model is developed to link the characteristics of small and medium-sized enterprises (SMEs), owner-managers and their firms performance together. Competitiveness is conceptualized as having three dimensions, namely potential, process and performance. This concept is also characterized by its long-term orientation, controllability, relativity, and dynamism. The use of this concept therefore provides us with a rationale for investigating the long-term performance of SMEs.

Following a review of the literature on SME competitiveness, we have distinguished between three key aspects affecting an SMEs competitiveness, including the internal firm factors, external environment, and the influence of the entrepreneur. These factors in turn impact the performance of the firm. [4]

3. COMPENSATIONS

A thorough understanding of internal incentive structures is critical to developing a viable theory of the firm, since these incentives determine to a large extent how individuals inside an organization behave.

Many common features of organizational incentive systems are not easily explained by traditional economic theory - including egalitarian salary/wages systems in which compensation is largely independent of performance, the overwhelming use of promotion-based incentive systems, the absence of up-front fees for jobs and effective bonding contracts, and the general reluctance of employers to fire, penalize, or give poor performance evaluations to employees.

Economic models of compensation generally assume that higher performance requires greater effort or that it is in some other way associated with disutility on the part of workers. In order to provide incentives, these models predict the existence of reward systems that structure compensation so that a worker's expected utility increases with observed productivity.

These rewards can take many different forms, including praise from superiors and co-workers, implicit promises of future promotion opportunities, feelings of self-esteem that come from superior achievement and recognition, and current and future cash rewards related to performance. [6]

There are two forms of compensations for employees: basic and additional.

1) Basic compensation (salaries / wages) are made up of different forms of motivation which are directed to ensure and improve the material position of employees and are considered as material compensation for the work.

2) Additional compensation consists of various types of benefits and long term incentives and it can be divided into material and non-material.

2.1 Additional material compensation - an individual incentive in the form of cash or other equivalent that an employee receives.

2.2 Additional non-material compensation - the one that contributes to raising the skills and knowledge of employees and where they do not receive cash or other equivalent from their employer.

Promotions, recognitions and other non-material compensation are visible mechanisms for allocating specific awards and evaluation of work within the policies and practices of each enterprise.

Support from enterprises, whether in the form of an additional material compensation or non-material compensation for them represents a financial cost. It is necessary to determine how much of the total cost is allocated to salary/wages and how much to the additional compensation.

4. COMPENSATIONS AND REVENUES

Employee compensation is one of the most-if not the most-important points of negotiation between employers and employees. Employers offer and negotiate compensation plans using a variety of wage structures and benefits to attract candidates for open positions and to retain employees.

Small employers offer compensation plans that account for the unique and varied characteristics of their business. These characteristics include industry, size of business, and years in operation, to name a few, although none are as important as business profitability.

Employees typically depend on wages, salaries, and so forth to provide a large share of their income and on benefits to provide income and health security. For employers, compensation decisions influence their cost of doing business and thus, their ability to sell at a competitive price in the product market.

In addition, decisions about compensation influence the employer's ability to compete for employees in the labor market (attract and retain), as well as their and behaviors while with the employer. [1]

Tournament promotion systems, in which the best performer at each level is promoted to the next higher level, provide performance incentives for employees.

In many cases, however, the best performer at one level in the hierarchy is not the best candidate for the job one level up - the best salesman is rarely the best manager, for example, and the best scholar is rarely the best dean. Firms that use promotion-based incentive systems commonly face problems with the loss of talented engineers, scientists and salespeople who insist on moving into management to realize promotion possibilities when none are available in their area of expertise.

Two-track systems attempt to resolve this, but they often fail when the technical promotions are to jobs with higher rank but no real purpose. Tournament promotion systems cannot simultaneously provide optimal incentives and matching. For matching to matter, employees must differ. For tournaments to provide optimal incentives, employees must be alike, since differences in ability lead to reduced incentives if participants know that those of high ability will win.

Tournament promotion systems cannot in general match employees to the jobs for which they are best suited. This is demonstrated by (Figure 1), which provides a plot of the output (net of wage) of two types of employees in jobs at three representative levels in the hierarchy entry level management, middle management, and top management. As drawn, employees of type A are the best top managers, while type-B employees excel in lower level management positions.

Relation between output (net of wages) in jobs at different levels in the hierarchy for employees of type A and B. Type A employees, who are best suited for top management jobs, will lose promotion tournaments at lower management levels [2].

A promotion tournament at the middle-management level, in which the best performing middle manager moves to the executive suite, will result in type-B employees being promoted to top management, which is clearly inconsistent with optimal matching.

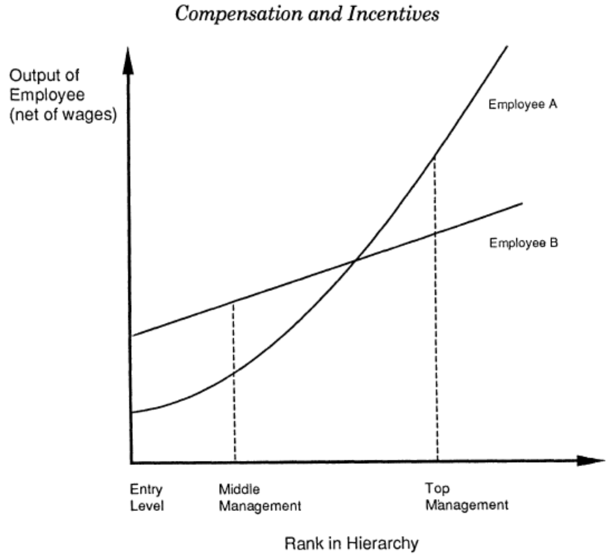

Figure 1. A plot of the output (net of wage) of two types of employees in jobs at three representative levels in the hierarchy

Both types of employees in (Figure 1) are assumed to be increasingly productive at higher levels, but the inability of tournament promotion systems to match employees with jobs is general and does not depend on these particular relations between output and hierarchical rank. In fact, matching problems in tournaments are even worse if output does not continuously increase as employees climb the hierarchy.

Each type of employee in is assumed to have an advantage over the other type in some jobs within the hierarchy.

There are two other situations that should be considered-the case where the relation between output and rank is the same for both employee types, and the case where one type "outproduces" the other type at all levels. Matching is important only when employees differ in their abilities to perform different jobs.

Therefore, matching is trivial in the first case where the employee types are identical. Matching is also trivial in the second case where one type dominates the other in all jobs, as long as employee skills are observable, since the firm will never hire any of the inferior type. When skills are unobservable directly, employees can be matched to jobs as information about the employee's talents and capabilities is revealed by experience.

Tournament promotion systems, in which the highest performing employee is promoted to the next level, can effectively match employees to jobs when talents are unobservable so long as the required talents for the next level in the hierarchy are the same as the talents required to win the tournament in the current job.

Tournament systems provide optimal incentives as long as employees believe all workers in the competition are equally talented, but handicaps are required to maintain incentives after information is revealed about unequal talents. [2]

A thorough understanding of internal incentive structures is critical to developing a viable theory of the firm, since these incentives determine to a large extent how individuals inside an organization behave. Many common features of organizational incentive systems are not easily explained by traditional economic theory-including egalitarian salary/wages systems in which compensation is largely independent of performance, the overwhelming use of promotion-based incentive systems, the absence of up-front fees for jobs and effective bonding contracts, and the general reluctance of employers to fire, penalize, or give poor performance evaluations to employees.

Economic models of compensation generally assume that higher performance requires greater effort or that it is in some other way associated with disutility on the part of workers. In order to provide incentives, these models predict the existence of reward systems that structure compensation so that a worker's expected utility increases with observed productivity. These rewards can take many different forms, including praise from superiors and co-workers, implicit promises of future promotion opportunities, feelings of self-esteem that come from superior achievement and recognition, and current and future cash rewards related to performance. [2]

First, salary/wages can be in the form of cash or benefits (e.g., health care, retirement, paid vacation). Health care has been the fastest growing benefit, and most employers describe the challenge of controlling this cost while providing quality coverage as one of their top human resource management challenges.

Second, both benefits and cash compensation can be described in terms of their level (how much). Most organizations use one or more market salary/wages surveys to help determine what other organizations salary/wages specific jobs in making their own salary/wages level decisions. More broadly, total labor costs are a function of both compensation cost per employee and total employee headcount. Therefore, to assess competitiveness in the product market, organizations should not focus only on salary/wages levels. They should compare total labor costs, and better yet, they should compare with other organizations the sort of return (or productivity) they receive in terms of profits, sales, and so forth for each dollar spent on labor costs.

The now common announcements of major reductions in force attest to the importance of controlling labor costs. Such decisions are also sometimes driven by comparisons of revenue or profits per employee, or the ratio of sales or profits to labor costs.

Third, the structure refers to the nature of salary/wages differentials within an employing unit. How many steps or grades are in the structure? How big are the salary/wages differentials between different levels in the structure? Are employees at the same hierarchical level in different parts of the organization (e.g., different product sectors or different occupational groups) paid the same? Yet another aspect of structure is the timing of salary/wages over employees' careers.

Some organizations may bring entry level people in at a relatively high rate of salary/wages, but then provide relatively slow salary/wages growth, while another organization may bring employees in relatively low but offer greater opportunities for promotion and salary/wages growth over time.

Fourth, salary/wages systems differ in their mix (how and when cash compensation is disbursed). Some organizations set salary/wages for all employees as a base salary that is adjusted approximately once per year through a traditional merit increase program.

Merit increases become part of base salary and are supposed to depend on merit (performance), although there is a widespread belief that most employees get about the same percentage increase, regardless of their performance. As described below, an increasing number of organizations are using so-called variable salary/wages or salary/wages at risk, which means that some portion of employees' salary/wages is uncertain and depends on some combination of future business unit or organization performance (e.g., profits, stock performance, productivity), group performance, and individual performance.

Specific salary/wages programs that influence salary/wages mix are merit salary/wages, incentive salary/wages, gainsharing, profit sharing, and stock plans (e.g., stock options).

Fifth, salary/wages is administered differently in different organizations. The design of salary/wages policies differs, for example, in terms of who is involved in the process. The roles of human resource departments, line managers, and rank and file employees differ across situations.

In some organizations, line managers may design plans, often with assistance from the human resources department.

Employees to be covered by a salary/wages system are sometimes involved, and in some cases, may actually design plans for themselves.

Communication is another aspect of administration. The most technically sophisticated salary/wages plan can generate desired employee reactions or exactly the opposite. The actual effect depends on whether the rationale for the salary/wages plan is understood and accepted and whether employees' perceptions of the facts upon which the rationale is built (e.g., the company's financial health, the salary/wages of employees in other jobs or organizations) are the same as the perceptions of those charged with seeing that the salary/wages plan has the intended effects. [1]

Figure 2. The influence of financial investment to the employee satisfactions and financial results

Revenues are all the earnings which the enterprise achieved in the production of products, the provision of services.

When we say business performance of the enterprises we think on the financial results of enterprises and employees satisfaction (Figure 2). The process of development of this model will allow enterprises acceptable financial investments that would ensure the motivation and performance of employees, which in the end should demonstrate the successful growth of the total results expressed in terms of the total revenues.

The area of compensation policy in SMEs is very interesting and important for researchers. This is proved by many conducted studies by different authors worldwide. Some of those authors are Ravi K. S and Dr. Santosh Kumar A. N [7]. They explored this issue on the sample of nearly 400 manufacturing companies in India. They concluded that a significant difference in the mean agreeability scores on financial and non-financial performances of small and medium sized enterprises exists when it comes to examining relationship and impact of compensation and rewards practices on organizational performance. Also an association exists between those organizations who adopt formal compensation and rewards practices with financial and non-financial performances of small and medium sized enterprises. Using the statistical program ANOVA they came to the conclusion that the analysis of variance shows that there is significant difference in the mean agreeability scores on financial performance and non-financial performance of SMEs and the mean agreeability scores are high among the enterprises that adopt formal compensation and rewards practices.

5. CONCLUSION

Employee compensation is one of the most important negotiation points between an employer and their employees, and is one of the largest expenses for a business. Given the fact that employees and enterprises are closely linked, we conclude that the individual and organizational goals are in a causal connection. The goals of every employee, next to the appropriate salary, are his/her personal satisfaction, motivation, good organizational condition and opportunity for development. Additional material compensation (money earnings) and additional non-material compensation (the one that contributes to raising the skills and knowledge of employees) represent opportunities for development, better satisfaction, motivation and stimulus for better individual and organizational results which is the aim of every enterprise.

Stimulation and rewarding system for employees are considered as effective instruments to harmonize the interests of employees and enterprise. Therefore, defined compensation policy could effectively respond to these challenges and ensure that the enterprise offers a flexible response to every change in the frequently turbulent environment.

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