THE RELATIONSHIP BETWEEN COMPENSATION SYSTEM (FINANCIAL AND NON-FINANCIAL) AND EMPLOYEES' MOTIVATION

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This project is submitted in partial fulfillment of the requirements for a Degree of Bachelor of Science with Honours (Human Resource Development)

Faculty of Cognitive Science and Human Development
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The project entitled 'The Relationship Between Compensation System (Financial and Non-Financial) and Employees' Motivation' was prepared by Shirley Tan and submitted to the Human Resource Department of Faculty of Cognitive Sciences and Human Development in partial fulfillment of the requirements for the degree of Bachelor of Science (Honours) Human Resource Development.

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Statement of Originality

The work described in this Final Year Project, entitled
The Relationship Between Compensation System (financial and non-financial) and Employees' Motivation
is to the best of the author's knowledge that of the author except where due reference is made.

Shirley Tan
17246
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ABSTRACT

THE RELATIONSHIP BETWEEN COMPENSATION SYSTEMS (FINANCIAL AND NON-FINANCIAL) AND EMPLOYEES’ MOTIVATION

Shirley Tan

The purpose of this study is to determine the relationship between compensation system (financial and non-financial) and employees’ motivation. The compensation factors included are base pay or salary, performance-based pay, recognition and working environment. The objectives of this study are to investigate the relationship between various compensation factors and the employees’ motivation. A total number of 80 respondents from each department of the semi-government sector were chosen as sample for this study. Questionnaires were used as an instrument in this study. Descriptive statistic such as frequency and percentage was used to explain the demographic characteristics of respondents. Hypotheses were measured using statistical analysis, T-Pearson Correlation Coefficient and Multiple regression. The Pearson Correlations test shows a significant relationship between the monetary reward (base pay, merit pay, allowances and bonuses) and employees’ motivation. In addition, the implications of the study on compensation system theory and practice, methodological and limitation as well as recommendation for future research are also discussed.
ABSTRAK

HUBUNGAN ANTARA SYSTEM PAMPASAN (KEWANGAN DAN BUKAN KEWANGAN) DAN MOTIVASI PEKERJA

SHIRLEY TAN

CHAPTER ONE

INTRODUCTION

1.0 Introduction

This chapter expounds on the compensation system (financial and non-financial) that affect the employee's motivation behavior. The carried research explained some important aspects, which includes the background of the study regarding how compensation systems will affect employee motivation on job performance, problem statement from the previous studies or research, research objectives, conceptual framework, hypothesis, significance of study, definition of terms and limitation of study. This chapter is important because it identify the problem statement that are faced by most organizations and also to find out the objectives and hypotheses of the relationship between compensation systems.
1.1 Background of Study

The 21st century is a new era with great globalization and also competency among employees in an organization. The reward system is important to generate motivation among the employees in performing their tasks. Additionally, reward system either financial compensation or non-financial compensation is important in retaining the employees in an organization. Rewarding employees to perform their best in their job is different in the 21st century compared to past decades. This compensation system is to generate motivation among the employees to perform continuously to ensure the survival of their organization. Therefore, comprehensive compensation and benefit packages for its employees, either financially or non-financially are needed to be developed. The financial compensation includes basic salary or wages, performance-based pay bonus or other financial incentives bonuses, and as for non-financial compensation is consists of the recognition system that is appraised to employees who take initiative to perform well, conducive working environment, retirement plan, and so forth.

Organizations and human resource professionals are continually in search of ways to motivate and reward employees in order to increase their motivation and performance. One primary human resource tool that is used to affect motivation and performance is compensation (Lawler, 1971). Employee compensation plays a key role because it is at the heart of the employment relationship, being of critical importance to both employees and employers. Employees typically depend on wages, salaries, and so forth as a source of income and benefits to provide additional 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, compensation decisions influence the employer's ability to compete for employees in the labor market (attract and retain), as well as their attitudes and behaviors while with the employer. Employee compensation practices differ across employment units (e.g., organizations, business units, and facilities) on
several dimensions (Gerhart & Milkovich, 1990, 1992; Gerhart, Milkovich, & Murray, 1992). The focus of employee’s compensation literature has been on defining these dimensions, understanding why organizations differ on them (determinants), assessing whether such differences have consequences for employee’s attitudes and behaviors, and for organizational effectiveness. In the following discussion, we will briefly describe the basic dimensions of compensation and summarize some of the key theories used to explain the consequences of different compensation decisions.

The art of retaining good employees is not a simple task, particularly a project-based organization. This is due to the nature of business of the organization where most of the positions in the organization are removed after the completion of a project. This would result in a high turnover rate. In accordance with that, many organizations need to have a more comprehensive and attractive compensation package in order for employees to remain in the organization and most importantly to perform their best to deliver quality services to the client. This is the reason as to why organizations have to know the needs of their employees and reward them accordingly. A good compensation package will be able to attract and retain the best people in the business. Wright and Roy (1999) said that although it is obvious, but the success of a company may rely on its ability to attract and retain the best people to perform in the interest of the company. Whenever the phrase compensation and benefits are mentioned, people will tend to view it from the financial aspect only. In fact, the non-financial compensation that an organization can offer is equally important as its financial aspect in enhancing motivation on the job.

The needs of employees in our country are changing drastically. It can be seen that most people would rather work in urban areas compared to the rural areas where most jobs can be found in the manufacturing sector which is growing rapidly. Often, financial compensation such as salary and wages are the main attraction for employees to work and remain in the organization. However, as our nation progresses
to a better industrialized country, financial compensation does not have that much influence in attracting and retaining good employees any longer. This is because as our standard of living increases, people will demand for something more than just mere financial compensation. They would start demanding for compensation during the performance of the job, which includes the job itself and its environment such as recognition, interesting job duties, and comfortable working environment. Knowing this, organization today has to know the demand of their employees and compensate them accordingly.

Few studies have been conducted in financial and non-financial compensation and how they could affect job performance. For example, a study conducted on job motivation and job performance in the case of recipients for excellent service in a higher education institution by Noran Fauziah Yaakub and Habibah Eliss (1999), concluded that there are other factors such as good leadership, good working facilities and the employees ability that contribute toward job performance. Another study, conducted in Hulu Langat, Selangor by Zakaria Kasa and Zaidatol Akmaliah Lope Pihie (1997) on the work values of factory workers concluded that the respondents placed high importance on values like job security, career development, economic returns, working condition, creativity, lifestyle and human relation. However, these studies did not emphasized on non-financial compensation directly.

1.2 Problem Statement

Theoretically, this study is important to identify the importance of the compensation systems which influence the employee’s motivation behavior where employee’s motivation is the significant factor in managing people within an organization. It is important for the employees to understand the motivational aspect so that it can be identified. Compensation systems are the dominant factors in determining employees’ working behavior. Some research suggested that employees
may need a risk premium (higher pay) to stay and perform in a company with pay at risk (Conlon & Parks, 1990). Undeniably, high level of motivation may lead to high performance of job. These compensation systems will determine the success or failure of the organization and how it results in behavioral changes and the organization’s performance. This situation is important to ensure that the management level of the organization takes the compensation systems seriously so that it can boost the performance of the organization by producing motivated employees. This is due to several studies that were done which mentions when employees are motivated, they automatically reflect that feeling to the work and thus their performance will be increased.

From the past research findings by Kohn (1992), it is not guarantee that the compensation systems will motivate the employee’s behavior to perform better. He suggested that compensation systems can actually harm the productivity of the organization. His rationale is based on laboratorial studies where subjects work in isolation on a task for either pay or no pay. He concluded that the research is based heavily on the work of Deci and colleagues where rewarding a person using compensation systems will influence their perspective on whether they are performing the task based on their own interest or just being concerned on the pay they received. This will indirectly influence their work behavior (Deci, Ryan & Koestner, 1999).

Practically, recent research has developed a well-designed plan linking pay to behaviors of employees which generally results in better individual and organizational performances. One particularly study looks at the HR practices of over 3000 companies (Mark, 1995). In a more comprehensive review, Heneman reports that 40 to 42 studies looks at merit pay claim performance increase when pay is tied to performance (in Wesley, 1992). Another study of 841 union and nonunion companies found gain-sharing and profit-sharing plans (both designed to link pay to performance) increases individual and team performance up to 18 and 20 percent
(Cooke, 2001). These studies mentioned that with high outcome expectations, they are motivated to perform better and vice versa. Another study showed that about 95% of public school districts used a uniform salary schedule. However, merit pay and performance-based pay programs are attracting the attention of policymakers and educators across the nation. Critics of traditional compensation systems and newer alternatives pointed out the strengths of the system they support, but the limitations of individual systems are frequently misunderstood or unrecognized. To improve the viability of a new plan, WCER Fellow Debbi Harris suggests that policymakers and stakeholders conduct extensive analyses before implementation. In a recent Policy Brief, Harris examines the effect of different compensation systems on teacher’s behavior and students learning (2008).

1.3 Objective of the Study
The research objectives in the studies included general objective and also specific objectives which are used to study the relationships between the relevant variables.

1.3.1 General Objective
This study aims to study the relationship between compensation systems (financial and non-financial) and employee’s motivation behavior.

1.3.2 Specific Objective

- To determine the relationship between base pay or salary and the employee’s motivation.

- To determine the relationship between performance-based pay and the employee’s motivation.

- To determine the relationship between recognition system and the employee’s motivation.
• To determine the relationship between working environment and the employee’s motivation.

• To determine a dominant factor among four compensation system in influencing employees’ motivation.

1.4 Conceptual Framework

This section discusses all the relevant variables that are going to be included in conducting the research. The conceptual framework is divided into two categories which are independent variables and dependent variables. The independent variables are those variables that the researcher chooses to study in order to assess their possible effects on one or more other variables. Meanwhile, the dependent variable is the variable that the independent variable is presumed to have an effect on it. Therefore, the nature of the dependent variable depends on what the independent variable does to it, and how it affects it.

The independent variables in this research are the compensation systems that affect the motivation behavior of the employees. There are two types of compensation systems which are categorized as financial and non-financial such as base pay or salary, performance-based pay, recognition systems and working environment. For the dependent variables, it consists of the employee’s motivation behavior. Below is the study of the research framework:
**Independent Variables**

- Compensation Factors
  - a) Financial Compensation
    - Base Pay / Salary
    - Performance-based Pay
  - b) Non-Financial Compensation
    - Recognition
    - Working Environment

**Dependent Variables**

- Employees’ Motivation on Compensation Factors

Source: Adapted from U.S. Army Handbook (1973)

**Figure 1.1: Conceptual Framework of The Relationship Between Compensation Systems (financial and non-financial) and Employees’ Motivation**

1.5 Research Hypotheses

This section identified the types of relationship that are studies in this research. The following hypotheses are formulated for this study:

**H1.** There is a significant relationship between the base pay and employee motivation.

_Some pay systems set base wage as a function of the skills or education an employees possesses (Milkovich & Newman, 1996)_;
Ha2. There is a significant relationship between the performance-based pay and employee motivation.

* A study published in August 2003, based on empirical data, finds a positive correlation between performance-related pay and productivity in industry firm (Herneman, 1992).

Ha3. There is a significant relationship between the recognition systems and employee motivation.

* Employee recognition plays an important role in motivating the workers at Nicholas Food Ltd, in Merseyside, England (Robbins & Coulter, 2003).

Ha4. There is a relationship between the working environment and employee motivation behavior.

* The productivity and efficiency are affected by how people work, and then in turn is affected by their work situation (Forsyth, 1998).

Ha5. There is a dominant factor among four compensation system in influencing employees’ motivation behavior.

1.6 Significance of the Study

Significance of the study involved in the research studies are divided into four parties which consists of the significance to theory, methodology, practitioner and policy.
1.6.1 **Significance to Theory**

In theory, Vroom's (1954) expectancy theory helped clarify how compensation systems influence individual's job performance. Expectancy theory says that an employee can be motivated to perform better when there is a belief that the better performance will lead to good performance appraisal and that this shall result into the realization of personal goals in some form of reward. This is common sense for every single person in the organization. They all perceived that the most important aspect is the strong relationship between one's effort in performing a task with the performance results of one employee, performance and rewards encouragement, and lastly reward and satisfaction of personal goals.

Meanwhile in the practical sense, the theory should be implemented in the daily work performance as an inspiration in performing the tasks. By implementing the theory in daily work, employees will be motivated to perform well in the sense of performance improvement. They will perform well in every single task due to the fact they are motivated by the compensation systems where the most important aspect is the increment in their annual salary. The performance based pay also encouraged employees to perform well in order to deserve the financial compensation that is being issued.

1.6.2 **Significance to Methodology**

The research study was done to support past research that have been done regarding compensation systems and employees motivation behavior. This research study will influence the validity and reliability of the provided data for future research. Thus, future research can minimize the level of validity and reliability set and produce more relevant and accurate study. This study also believed it will increase the level of reliability and validity in terms of the instruments which is being used. The instruments used are very important to ensure all the results are reliable and