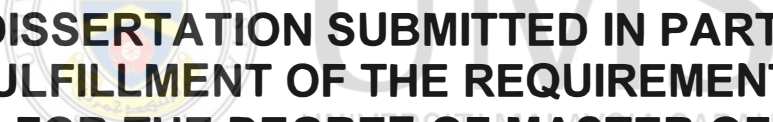


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**THE INFLUENCE OF COMPENSATION SYSTEM
ON EMPLOYEES' RETENTION: A STUDY ON
PRIVATE SECTOR EMPLOYEES
IN KOTA KINABALU**

AINAHWATI ABD.SANI



**A DISSERTATION SUBMITTED IN PARTIAL
FULFILLMENT OF THE REQUIREMENTS
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DECLARATION

The materials in this thesis are original except for quotations, excerpts, summaries and references, which have been duly acknowledged.

AINAHWATI ABD. SANI
PS03-002(K)-018
26 July 2006



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ABSTRACT

This study was carried out on private sector employees in Kota Kinabalu, Sabah. The aim of this study is to investigate on the existence of the relationship between compensation system and employees' retention. It has been revealed through past literature review that compensation system can be used to assess the likelihood of employees' retention, particularly in the private sectors. It is also the aim of this study to investigate whether working environment may moderate the relationship between compensation system and employees' retention. However, after conducting a questionnaire survey at several private sectors organization, with a sample of 105 respondents, it was found out that there was no significant relationship exists between compensation system and employees retention. In addition, it was also discovered that the moderating variable also had no effect towards the relationship. Nevertheless, the study was able to gather some information pertaining to the respondents' profile and what they expect from the employer and also provides some useful insights on what employees expect from the employer and also on what they look into for them to stay in the organization.



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ABSTRAK

PENGARUH SISTEM PENGGAJIAN KE ATAS PENAHANAN PEKERJA: SATU KAJIAN KE ATAS PEKERJA-PEKERJA SEKTOR SWASTA DI KOTA KINABALU

Kajian ini telah dijalankan ke atas pekerja-pekerja sektor swasta di sekitar daerah Kota Kinabalu, Sabah. Tujuan kajian ini adalah untuk mengenalpasti kewujudan hubungan di antara 'sistem penggajian' dan 'penahanan pekerja' di organisasi swasta, iaitu samada sistem penggajian mampu mempengaruhi keinginan pekerja-pekerja ini untuk bertahan di organisasi tersebut. Kajian terdahulu telah menunjukkan bahawa sistem penggajian mampu mempengaruhi tahap penahan pekerja di sesebuah organisasi. Di samping itu, adalah juga menjadi tujuan kajian ini untuk mengupas samada faktor persekitaran kerja boleh mempengaruhi tahap penahanan pekerja di dalam organisasi tersebut. Namun, setelah menjalankan kajian soal-selidik terhadap pekerja sektor swasta yang berkenaan, dengan menggunakan 105 responden, adalah didapati bahawa tidak terdapat kaitan yang signifikan ke atas system penggajian dan penahanan pekerja. Dalam pada itu, juga telah didapati bahawa variabel perantaraan yang telah dikemukakan tidak menunjukkan sebarang impak terhadap hubungan itu. Walaubagaimanapun, kajian ini telah memperolehi beberapa informasi penting berkenaan dengan profil responden dan apa yang mereka jangkakan daripada majikan mereka dan juga apa yang mereka kehendaki untuk bertahan di dalam organisasi tersebut.



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CHAPTER 1

INTRODUCTION

1.1 Overview

For the last several decades, the growing integration of the world economy into a single, huge marketplace has increased the intensity of competition in the world market to cut costs and increase profits in a wide range of manufacturing and services industries (Hill, 1994). Only the most efficient and best-managed organizations can survive.

Money, benefits and many different forms of compensation have been used to attract, retain and motivate employees and achieve organizational goals in the USA and around the world (Chiu *et al.*, 2001; Barber and Bretz, 2000; Rynes and Gerhart, 2000; Tang *et al.*, 1998, 2000a.b; Milkovich and Newman, 1999; Lazear, 1998). Compensation, a key strategic area for organizations, impacts an employer's ability to attract applicants, retain employees and ensure optimal levels of performance from employees in meeting the organization's strategic objectives. A critical balancing act must occur to ensure that compensation attracts, motivates and retains employees. At the same time, compensation should allow the organization to maintain a cost structure that enables it to compete effectively and efficiently in its markets. Societal norms are also changing, where loyalty to one employer is no longer the status quo. Managers across industries are faced with the increasing need to retain current employees and position their establishment to be more attractive to potential applicants.

1.2 Research Problem

In today's world, employers face challenges in retaining efficient employees in wake of rapid increase in the volume of work. Employers are struggling to find and retain good people at all levels to keep pace with the volume of work and this means new pressures on salaries and compensation for employees. Furthermore, employers caution about pay levels and compensation despite a strengthening market has led to increasing employee frustration. The market economy also motivates the employment situations to change constantly and the person who works his or her entire career for the same business is less and less common. If employees are staying with the organization from two (2) to five (5) years, then the employer probably has done what is realistically and necessary to retain employees.

The higher the pay level, the higher the labor costs. Organizations with a high pay level may attract and retain a qualified workforce (Williams and Dreher, 1992) and reduce training or recruiting costs due to employees' higher quality and/or quantity of performance (Pfeffer, 1998). The organization size, location and the type of industry may influence the pay levels (Tang *et al*, 2000a,c). Second, employee benefit costs have jumped from 25% of payroll in 1959 to just over 41% in 1993 (US Chamber of Commerce, 1994). Organizations also need to strike the balance between wages and benefits in order to satisfy employees' needs and stay competitive.

Therefore, there is a need to study whether compensation can attract people to stay. Nevertheless, this research would be conducted based on a few questions that maybe worth to ponder as a guideline for the researcher in achieving the desired result for this research.

These questions would include:

- (i) Does compensation system influence the employees' intention to stay in the organization?

- (ii) Does employees' working environment has a moderating effect on the employees' intention to stay in the organization?

In addition, the questions posed above may also be summed up in a single problem statement ***"The compensation system may affect the employees' intention to stay in an organization which would be moderated by the employees' working environment"***.

1.3 Purpose of the Study

The main purpose of this study would be to gauge the extent to which compensation system affects the employees' intention to stay in the organization, being moderated by working environment. Besides, it is also the objective of this study to examine whether working environment moderates the relationship between compensation system and employees' intention to stay in the organization.

Money is the instrument of commerce and the measure of value. "Money is not everything but it is the best metric" (Lazear, 1998:379). The meaning of money is "in the eye of the beholder" and can be perceived as their "frame of reference" in which they examine their everyday lives (Tang *et. al.*, 2000a: 217). On the other hand, some benefits are quite important to employees. The same benefit does not suit every worker. Workers do differ in their valuation of various benefits. Thus, a cafeteria plan for example, which gives a worker more flexibility in benefit choices, can provide the most value to the worker for a given amount of expenditure. Researchers and managers of human resources and compensation need to identify the most important compensation components and satisfy employees' needs.

Numerous researchers have suggested that human's need structures are virtually universal among individuals (Herzberg, 1987a, b; Maslow 1970; Alderfer, 1969). Others have argued that need structures are culturally bound (Tang and Ibrahim, 1998; Tang and West, 1997; Smith *et al.*, 1995). Thus, we cannot assume that all employees have identical favor to compensation components in organizations.

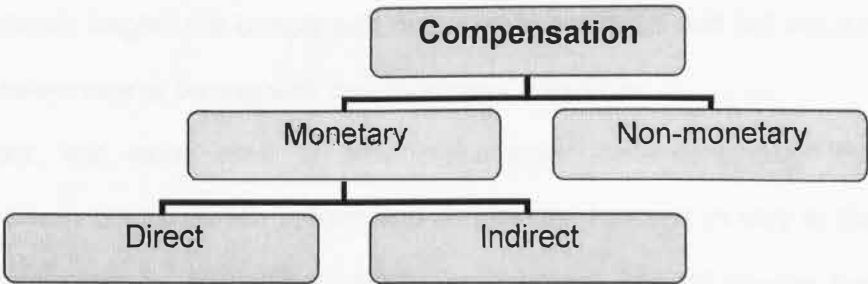
1.4 Scope of the Study

This study will look into the employees’ intention to stay in the organization. A number of private sector employees would be selected namely from the hotel, banking and construction industry as well as employees from other private sector companies. Employees from hotel, banking and construction industry are mainly selected because these three (3) industries are well-known for their turnover or mobility. This high turnover phenomenon is also prevalent in Malaysia. For instance, the local turnover rate for operational hotel workers was reported at 65.7% for the year 1998/1999 (Malaysian Association of Hotels, 2000).

In addition, this study is mainly focused on private sector employees because they have the tendency to move from one organization to another organization as compared to employees from the government sector. Therefore, their selection as respondents is more appropriate. With regards to level of position in the organization, the questionnaires are to be distributed to private sector employees in Kota Kinabalu at clerical level and above. This is to ensure that the collection of data is easily monitored and controlled as well as consistent.

Organizations’ reward systems involve monetary compensation and non-monetary rewards. Further, under monetary compensation, there are direct compensation and indirect compensation (benefits). This is depicted in Figure 1.1.

Figure 1.1: Compensation Components



In this study, the researcher will focus on monetary compensation in organizations. First, pay level is related to two (2) objectives in compensation:

- (i) controlling labor cost; and
- (ii) attracting, retaining and motivating employees

Many studies have investigated the relationship between compensation system and attraction, retention and motivation of US employees (Barber and Bretz, 2000; Gerhart and Milkovich, 1990; Kahn and Sherer, 1990). Very little research however, has investigated the various compensation components in retaining people in the Malaysian context.

The major purpose of this study is to achieve the following two-fold objectives:

- (i) to identify whether compensation system plays an important tool in retaining employees
- (ii) to identify employees' perceptions on the most important factors that influence their stay in the organization

1.5 Significance of the Study

The loss of talented employees may be very detrimental to the company's future success. Outstanding employees may leave an organization because they become dissatisfied, underpaid or unmotivated (Coff, 1996) and while trying to retain employees within the organization, they may present other challenges as well. They may demand higher wages, not comply with organization practices and not interact well with their co-workers or comply with their managers' directions.

Therefore, this study aims at providing a clear understanding of the relationship between compensation system and employees' intention to stay in the organization, moderated by employees' working environment. The information and the results of this study would be crucial to the employers in designing a competitive compensation system for the employees, with the objectives to retain good

employees. It is expected that the outcome of this study would make an impact on the influence of compensation system has on employees' intention to stay in the organization as well as retention strategies.

1.6 Definition of Key Terms

For the purpose of this study, the following terms may need to be further clarified to avoid confusion on what is meant in the context of this study

1.6.1 Compensation System

An organization's compensation system usually consists of three (3) separate components, as illustrated in Figure 1.2. The first and largest component is the base compensation or salary system. The second is the incentive system, where employees receive additional compensation based on individual, divisional and/or organization-wide performance. Third is the indirect compensation system, where employees are provided with certain benefits, some of which are legally required and others are provided at the discretion of the employer.

1.6.2 Retention

Retention is defined as possession or use of something or action of holding something in position or containing it. In this context of study, retaining employees is defined as one's desire to stay with the organization. Retention also leads to organizational commitment. It is defined as a strong belief in and acceptance of the organization's goal, a willingness to exert considerable effort on behalf of the organization and a definite desire to maintain organizational membership (Porter *et al.* 1974). It has also been defined as a state in which an employee identifies with a particular organization and its goal and wishes to maintain membership in the organization (Robbins, 2001).

Retention has many definitions but they can be understood to suggest that employees are attached to their organization and intend to have a long-lasting relationship with the organization.

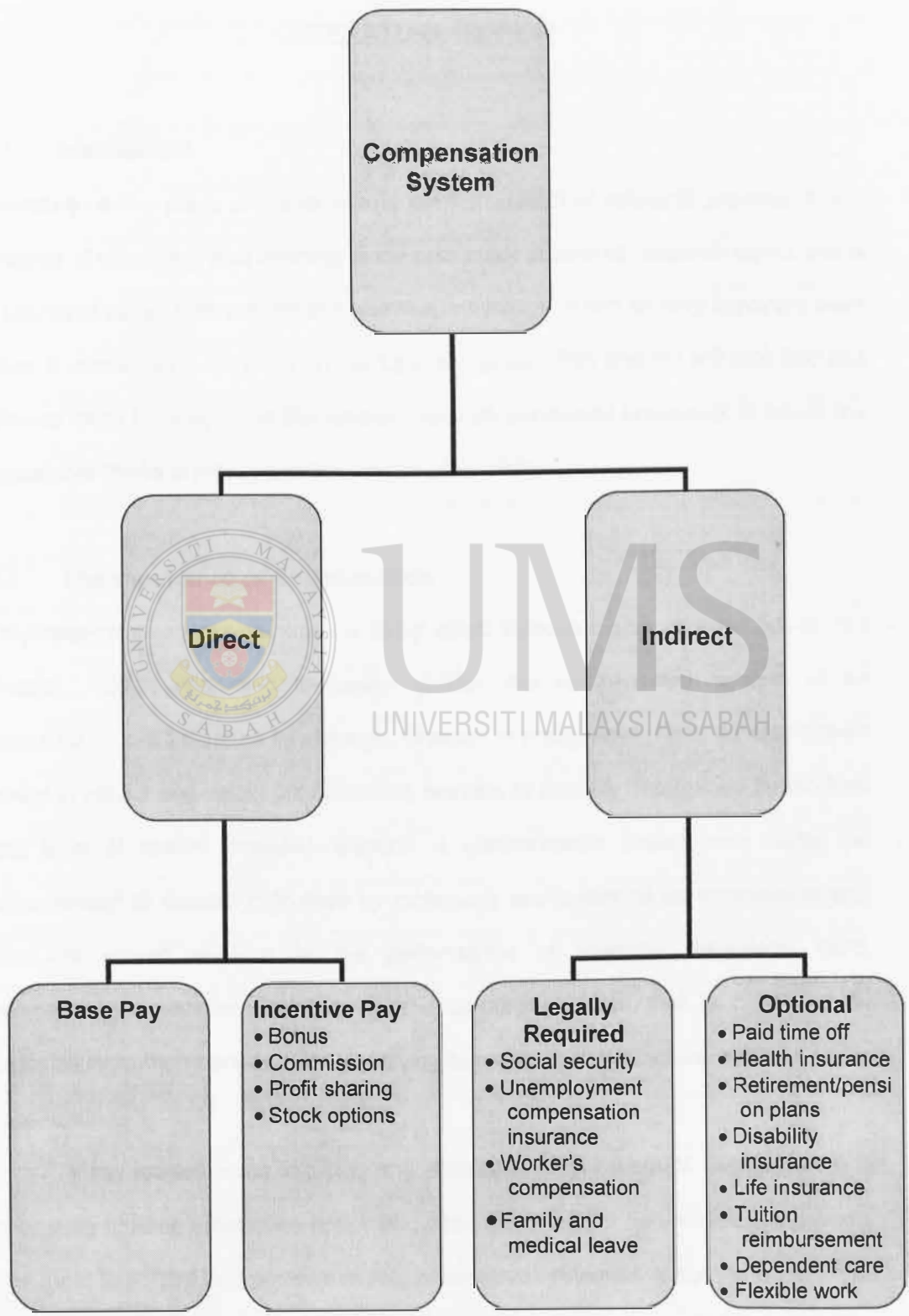
1.7 Summary

This chapter basically gives the readers the fundamental idea of what the proposed research will be all about. It includes information on what the study hopes to investigate, what the focus of the study is, its significance as well as definition of key terms in which this study will be based on. This is to facilitate the understanding of the readers.



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Figure 1.2: Compensation System



CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

Literature review plays a crucial role in the formulation of research projects. It is a process of identifying and bonding to the previously published research topics and is a source of ideas, both substantive and methodological. It can be very important even when it uncovers no literature on the topic of interest. This chapter will look into and discuss more thoroughly on the various research conducted previously, in which the researcher thinks is relevant to the subject of interest.

2.2 The Importance of Compensation

Employee-retaining policies have a direct effect through higher salaries (Idson and Feaster, 1990). According to Lawler (2000), the compensation system of an organization can influence its strategic direction in many ways. First, an enterprise's ability to attract and retain conscientious workers is partially determined by the kind and level of reward provided. Second, a compensation system may foster the achievement of desired outcomes by motivating employees of an organization and can link valued rewards to the performance of essential behaviors. Third, compensation systems contribute to the corporate culture that is perceived by organizational members as well as serving to reinforce the structural systems of the organization.

Many factors come into play and a balance must be struck between what is necessary to keep employees happy and what the employer can realistically provide. The most important and obvious aspect of employee retention is compensation. The 473 respondents to the Strategic Human Resource Management (SHRM) *Retention*

Practices Survey (SHRM, 2000) believed that the most common reasons for employee turnover are better career opportunities, compensation and benefits offered elsewhere. The large academic literature on employee retention indicates that organizations can enhance employee retention by providing among others is competitive compensation. The factor of compensation indicates people will leave for higher compensation elsewhere (Klara, 1997; Castagna, 1997; Crandall *et. al*, 1996).

Companies in the USA are moving toward pay systems that are flexible and strategically aligned with complex and changing business environments (Lawler, 2000). Examples include the increasing use of competency based pay, in which pay is geared more to individual's skills and abilities that contribute to company success than the job individuals perform and broad banding.

Perhaps the most significant trend, however, is the increasing use of "variable pay" plans. Variable pay (often referred to as incentive pay) plans conventionally refer to payments that are based on an objective or quantitative assessment of individual, group or company performance, that do not add to base salary. Examples include bonuses, gain sharing plans, profit sharing and stock based plans. According to a report by Hewitt Associates (28 August 2000), 78% of surveyed organizations currently have at least one type of variable pay plan in place, up from 70% in 1999 and 47% in 1990. Variable pay does not add to base salary and thus can be much larger on average in any one time period and more noticeable and motivating. Variable payments are also increasingly being tied to team, unit or company performance, as opposed to individual performance, allowing organizations to reward individuals for team or group related effort. At the same time, the use of merit pay is declining (Hewitt Associates, 2000).

There is a significant amount of evidence indicating that low pay is one of the most common causes of turnover in the hotel industry (Pavesic and Brymer, 1990; Pizam and Ellis, 1999). It follows that managers whose salaries are low will attempt to change their positions by engaging in a search for alternatives. Leaving the

organization for a better-paid position becomes an attractive proposition and makes turnover cognitions more frequent.

A Computerworld hiring survey (December 1997/January 1998) found that 70% of IT professionals said they left for more money, coupled with 64% who also left for career advancement. Participants in this study also agreed that offering a valued employee more money to stay (i.e. at least equal to or greater than the prevailing industry local salary level) was instrumental in getting them to stay.

2.3 Retention

Once quality employees have been identified and have become an integral part of the organization, the challenge to the employer is to retain them. Employees who are more committed are less likely to have the intention to leave their jobs (Mathieu and Zajac, 1990) or to actually leave (Netemeyer *et al.* 1995). Employees with strong affective commitment contribute more to the accomplishment of organizational goals and they are also less likely to leave the organization. Employees with high degrees of continuance commitment are also less likely to leave the organization (Sethi *et al.*, 1996).

Retention of talented employees can be a source of advantage to an organization. But there are challenges in attempting to retain these employees (Barney, 1991; Wernerfelt, 1984; Pettman, 1975). In a perfect world, the productive employees are encouraged to stay within the organization and the non-productive poor performers are encouraged to leave. In fact, if it were measurable, a company would keep each employee: 1) whose contribution produces a positive risk adjusted profit for the firm and 2) who will also have a more positive influence on the firm than any employee hired to replace him or her (taking into account the cost of hiring the new employee). But because of problems such as asymmetric information, it is not an easy task to carry out this goal.

According to Min and Emam (2003), employees who have stayed with the same organization for more than six (6) years are more likely to stay with the same organization. According to a survey published in Information Week, October 10, 2005, Issue 1059, compensation came at number four (4) with 9% votes for the top five (5) reasons for an employee to stay in a position. Meanwhile, when respondents were asked what the company could have done to keep them, they put 'increased compensation' as number three (3) reason with 16% votes.

Another survey conducted by PAS Inc., a Saline, Michigan-based construction compensation consultant of contractors and construction management firms, contractors anticipate giving staff average salary increases of 3.68% in 2005. The increase in contractors' business has led to a heavy demand for people. In an independent research study commissioned by the American Society of Interior Designers (ASID), 663 adults were given carte blanche to list the factors that influence their decisions to accept or leave jobs. It was found out that 62% of respondents cited 'Compensation' as the number one factor that influenced their acceptance for jobs.

In Europe, Furlonger (1997) also suggested that retention plans should be regularly monitored to ensure a competitive compensation package and that failure to meet the challenge will mean a further attrition of the skills base. When people leave, a company has to make up the shortfall by subsequently paying substantially above average.

2.4 Employees' Working Environment

Nothing will improve an organization's ability to attract and retain employees better than offering higher salaries and more benefits than its competitors. Studies show, however, that providing a better working environment can also be an extremely effective tool for attraction and retention. In an independent research study commissioned by the American Society of Interior Designers (ASID), 663 adults were