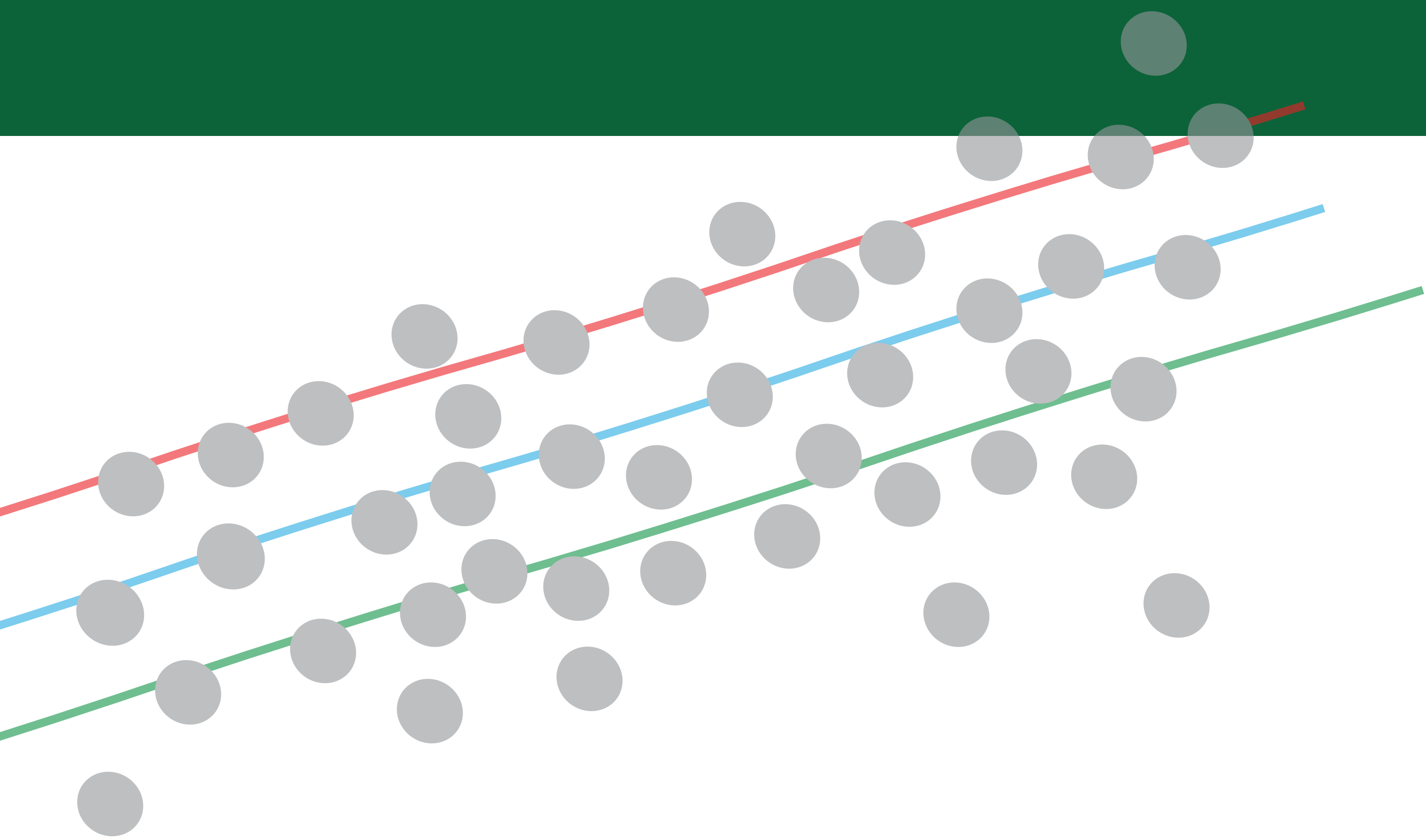
How to Plan Salaries



ECONOMIC RESEARCH INSTITUTE

8575 164th Avenue NE, Suite 100
Redmond, WA 98052
800-627-3697
www.erieri.com

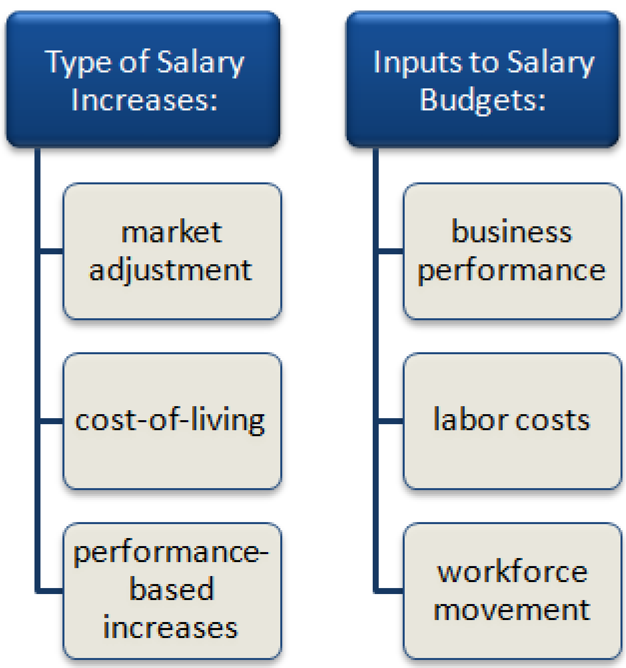
This learning aid serves as a salary planning resource. Salary is one of the financial levers used to attract, retain, and motivate talent. It is also the largest line item in financial statements, represents a fixed cost to the organization, and has a cumulative effect on cash flow. An effective salary plan requires involving the right stakeholders and working through a collaborative process.

Distilling Labor Costs

Strategic workforce plans generally include labor costs provided from multiple sources, reflecting these groups:

- Permanent employees – This includes full-time or part-time employees and those eligible for benefits.
- Contingent employees – This includes fee-based or temporary employees and generally entails a more variable cost.
- Outsourcing - This is a contractual relationship with another organization. The terms of the agreement determine how fixed or variable this is.

Salary planning focuses on permanent employees hired into jobs that the organization deems to be critical to its business operations and sources of competitive advantage. One of the organization's goals will be to retain and motivate permanent employees. To establish a salary plan, it is necessary to determine what types of salary increases will be available and forecast a salary budget.



Types of Increases

Market Adjustments

Some organizations decide to follow a market pricing approach for critical, strategic job functions or perhaps across the entire organization. A pure market pricing approach requires a consistent commitment to investment in multiple sources of compensation data. Other organizations choose to use a hybrid approach that uses a compa-ratio derived from both a job worth hierarchy and market pricing.

Cost of Living

Cost of living (COL) is NOT reflective of the changes in the labor market; rather, it is a set of costs that includes housing, taxes, consumables, services, transportation, and miscellaneous costs. Housing and taxes usually take up the bulk of an individual's costs on a graduated basis. COL can be taken into account, especially during periods of high inflation, when employees see a deterioration of their "real wages." Data used to externally benchmark COL increases can come from a private cost-of-living survey performed in your area or you can rely on the U.S. government's Consumer Price Index (CPI).

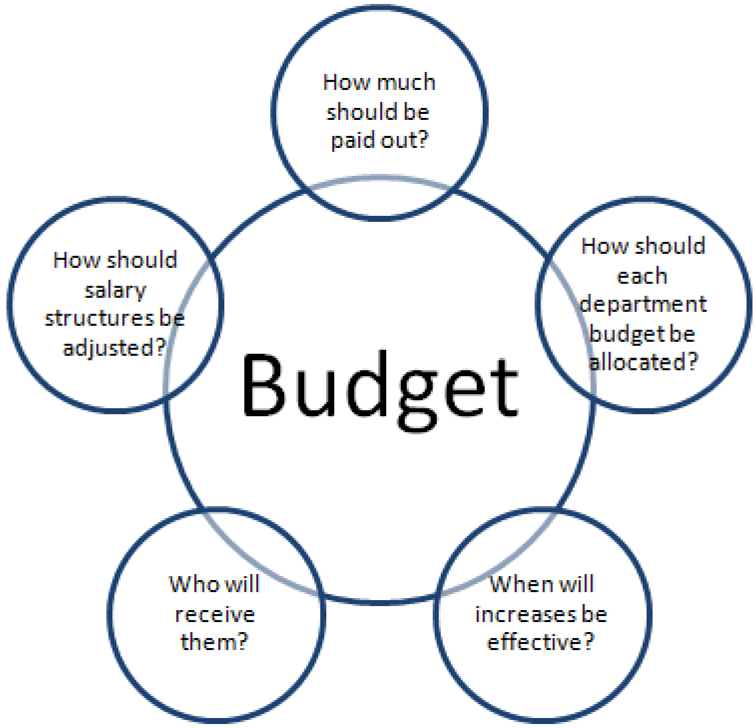
Performance-Based Increases

Many organizations grant pay raises based upon performance in the current job, as part of a merit increase, or for a promotion. Performance based systems should meet these criteria to effectively achieve business results and intended outcomes.

- A performance appraisal process should be understood, trusted, and credible to employees.
- Performance should be properly connected with metrics, goals, and subsequent salary increases.

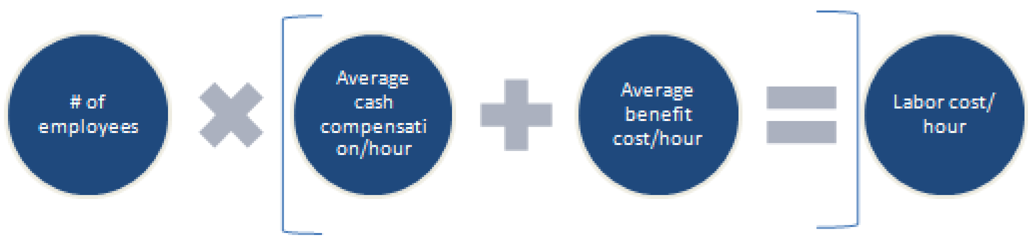
Budgeting for Salary Increases

Once your organization has selected the type of salary increases it will offer, a budget can be created by evaluating these input sources:



Three types of inputs are required when setting a budget for salary increases:

1. **Business performance** - Measured differently based on the industry, company and the business cycle.
2. **Labor costs** - Forecasted on a per unit basis using the standard calculation below.



Labor is expected to be more productive due to automation or technological changes; the average labor cost per hour may rise while the total number of employees declines. If the average productivity level doesn't change dramatically with technological change, determine whether the increase can be passed on to customers or offset by a reduction in other expenses.

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3. Workforce movement with associated pay rates

The impact of turnover and attraction are dependent on the industry and specific labor markets and have by-products that directly impact labor costs:

- **Salary saving** - Each time an employee leaves the organization, the time the vacant position remains unfilled reduces the total cost of salary increases.
- **Churn or slippage** - New employees brought in to replace longer tenured employees are hired at lower rates than the former long-tenured employees.
- **Pay compression** - When newly hired employees earn more than longer tenured employees in the same jobs.

Budgeting Process

Depending on the business objectives and organization culture, organizations will consider two approaches to build a budget:

Bottom up - Organizations that have some degree of decentralization and are focused on performance and growth may use this approach, which entails the following steps:

1. Each supervisor indicates pay changes that they want to assign to each employee during the year and provide input to the workforce movement assumptions.
2. The supervisor's input is then reviewed by the manager and then "rolled-up" until an overall organizational budget is set.
3. At each review, congruence with pay level, structure policies, and group performance are assessed.
4. The final outcome is communicated, providing rationale and transparency.

Top down - This approach involves the following steps:

1. The budget is set for the organization as a whole. It is then apportioned to each organizational unit.
2. The allocation process is repeated a number of times until each manager ends up with a given amount of money to allocate to pay increases.
3. Since this approach is less collaborative, the final outcome may receive "push back" from supervisors and other performance managers.

Implementation

Once the budget has been determined, the salary planning process can be implemented and will general require the following:

Training

Managers should be given guidance about the nature of the company compensation program and how to use the company guidelines and budget technique to respond to salary increase requests. Managers must also be given information regarding salary ranges and labor market data.

Tools

Managers should have the necessary information to effectively plan salaries, including the following:

1. Guidelines should be written broadly to allow managers the ability to adapt to current needs. Focus on developing procedures is aimed at achieving a balance between administrative ease, delegated fiscal accountability, and program effectiveness. Consider these examples:
   a. Participant guideline:
      - New employees are not eligible for a pay increase for six months and increases are pro-rated.
      - An employee who has been recently promoted or otherwise received a base salary increase in a similar six month period would also not be eligible to participate.

   b. Increase grid guideline:

Performance	% Increase
Excellent	6.0%
Above average	4.5%
Average	3.0%
Below average	2.5%
Poor	0%

2. Employee and position data:
    a. Employee name and identification data
    b. Position title
    c. Grade or level
    d. Current base salary
    e. Current compa-ratio
    f. Type, date, and amount of last increase
3. Manager planning information:
    a. Proposed increase
    b. Date of increase
    c. New compa-ratio
    d. Planned exits from the unit (resignations, retirements, leaves of absence, transfers)
    e. Planned increases in personnel (including salaries)
    f. Expected total increase in both amount and percentage.

Monitoring and evaluating the budget during the year

It may be necessary to periodically compare actual increases and labor costs with the budget and take action as necessary. See if expenditures are kept under control or whether events have changed the forecasts.

Here are some proactive cost control practices:

a. **External** - Do spot checks of a salary survey to see if the market is behaving as expected.

b. **Internal** - Get a "pulse" on the employee acceptance of internal pay relationships and monitor union grievances, requests for reclassification of jobs, turn over rate, or other indicators specific to your business/industry.

Conclusion

Setting salary planning budgets and effectively managing those budgets requires a collaborative process with both business and industry insight. Key inputs are cost and value drivers of your business as well as industry labor and competitive conditions. This learning aid has outlined such an approach. For more information, please contact ERI Economic Research Institute at 1-800-627-3697.

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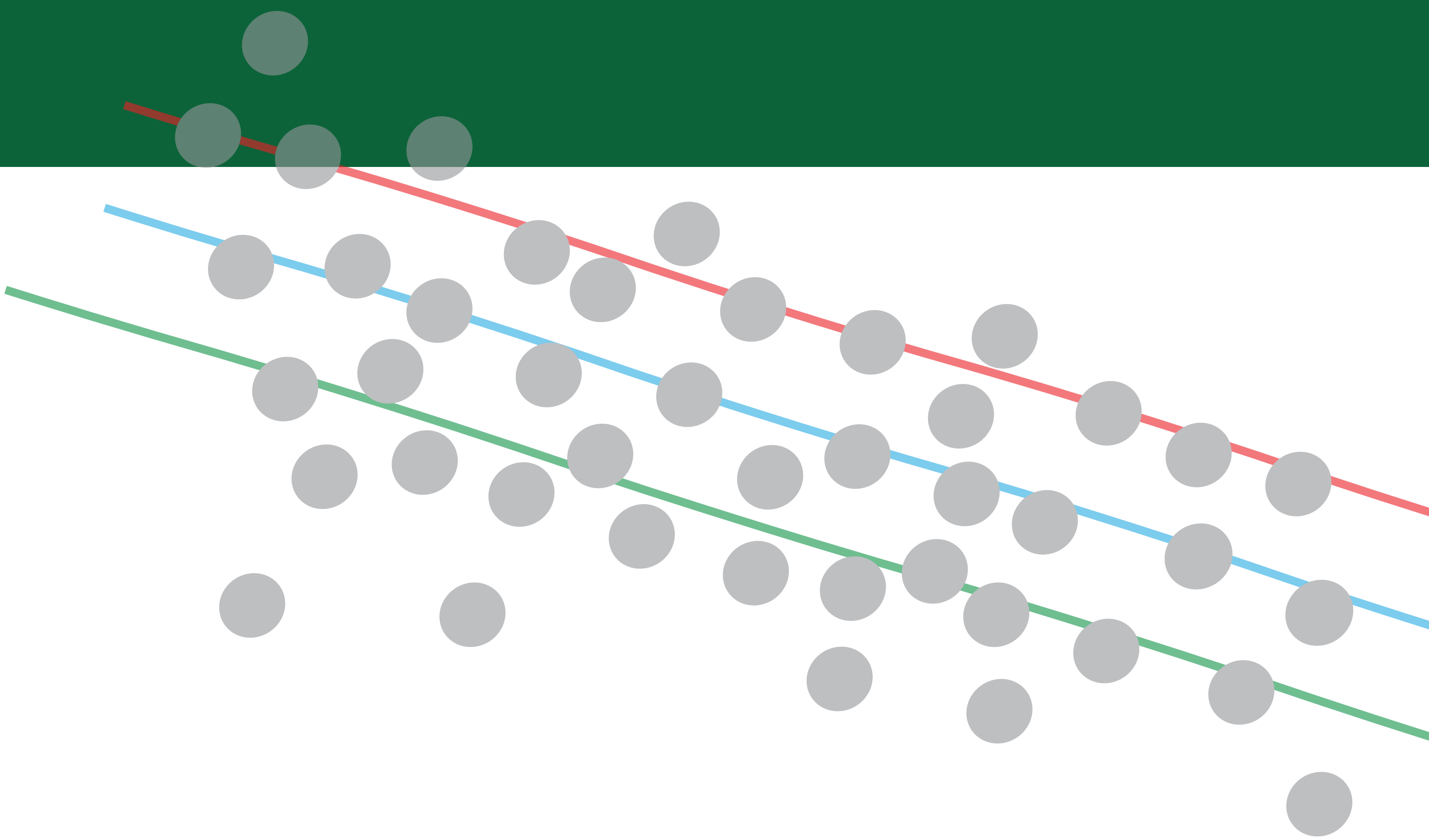

www.erieri.com | U.S. Toll Free 800-627-3697 | sales@erieri.com