



Salary Increases ... *or Not?*

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Introduction

Most employers these days continue to struggle with decisions around salary adjustments. Who should get them? How can the cost be justified? What if the employees are already overpaid? And, if they are overpaid, but are stellar performers, what should you do? Can you withhold increases for some while granting them for others without appearing to be unfair? What if there’s been a salary freeze for a year or more? These questions can all be answered by considering the organization’s intentions, resources and past practices.

What We Have Observed and Why It Matters

We know from experience of working with more than 800 clients that employers who don’t have a defined structure and systematic approach to managing base pay tend to overpay about 25% of their employees and underpay another 25% of them, leaving only about half of the employees actually paid between plus/minus 10% of the job value or midpoint.



Of course, these data can be compiled only after the organization has developed a job classification system, and the job values have been established and compared to actual employee salaries.

Given that employers generally intend to pay their employees cost-effectively, competitively, and equitably, these data are disturbing. Underpaid employees are at risk of leaving, especially as the economy improves, and this undesirable turnover will result in the high costs associated with replacing them, which some experts estimate at as much as 100% of annual salary. In addition, underpay situations can put the company at risk for decreased morale and engagement, as well as potential pay discrimination lawsuits, if illegal adverse impact is involved.

Meanwhile, overpaid employees cost the company more than necessary in payroll and pay-related benefits costs. Giving overpaid employees increases not only results in having them more overpaid than before, but such increases also become annuities — ongoing costs that continue year after year. Not exactly a cost-effective situation.

Causes of Misaligned Pay

How do these situations arise in the first place? Even when jobs are correctly priced in the market, the use of wide, broadband ranges, “merit” increase matrices, and other commonly used administrative practices that lead to annual entitlement increases, simply perpetuates any pay inequities that already exist. In addition, the determination of new hire salaries, usually the result of negotiating, often results in initial salaries that are too high or too low, and which become “cast in stone” for the duration of the employee’s tenure with the company. In these cases, annual increases do nothing more than maintain the inequities from year to year.

How Can Employers Fix This Problem?

Correcting these situations is often a two-step process: (1) make special “equity” adjustments as necessary and affordable to result in competitive, equitable salaries for underpaid staff, and (2) upgrade ongoing salary administrative practices to focus on actual pay rather than just on increase percentages for subsequent years.

Step One: Initial Action

Once the problem is defined, the first step is to create a scenario, usually through trial and error, that will determine under which specific circumstances any salary adjustments will be made based on percentages that represent “ideal” pay for individual employees based entirely on two factors: (1) how much their job is worth, and (2) their performance level.

For example, one starting scenario might be defined as follows:

Scenario Example:	
<u>Employee Situation</u>	<u>Ideal Base Pay as % of Job Value</u>
New Hire	90%
Needs performance improvement	90%
Fully satisfactory performance	100%
Outstanding performance	110%

Under this scenario, all employees with fully satisfactory performance ratings whose compa-ratios are less than ideal will receive an adjustment in an amount that will result in a new salary that is equal to the indicated ideal percentage job value. (Compa-ratios are actual salaries as a percent of the job values or midpoints for the job.) The scenario can be more or less definitive, as desired. When the employer knows the cost to bring all employees to their ideal pay, the scenario can be modified to accommodate their budget by altering the ideal pay percentages.

One assumption usually made as a part of the costing process is that individuals currently paid more than their ideal salary will not receive salary adjustments. If necessary, employers can consider the payment

of one-time only lump sum amounts in lieu of increases as a way to ease fully-performing employees who are not receiving increases into accepting the new policies.

In rare cases, some employers consider implementing salary reductions, especially for individuals who are not fully performing. Many factors enter into this decision, and it is not commonly done.

Step Two: Ongoing Administration

This step involves the development of the organization's ongoing pay philosophy statement and policy guidelines. If adjustments to these defined ideal pay levels, as noted above, cannot be made due to cost considerations in the first step, as described above, they should be targeted to be paid according to policy during the next and/or following years.

The Difficult Problem of Overpaid Employees

There will undoubtedly be employees who will not receive salary increases in step one, or even in step two, due to being already paid more than the ideal. Obviously, the funds saved from withholding such increases will be helpful in adjusting the salaries of those who are underpaid.

From our experience, roughly 5-10% of total payroll costs can be saved by managing salaries in a disciplined way. One of our clients recently calculated that they could save close to a million dollars over the next two years simply by freezing the salaries of overpaid employees.

During the current economic downturn, some of our clients actually reduced salaries for individuals who were significantly overpaid. When you decide to decrease and/or freeze salaries, make sure that it is done consistently and within the guidelines and scenarios you establish.

It's especially critical to handle freezes or decreases of pay carefully, particularly with respect to employees who are valued performers, and those you need to retain. In addition to the lump sum payment option, you can consider the following options, as they may apply:

- Offer cash incentive bonus opportunities based on measurable performance results
- Carefully analyze the individual's job functions/roles to determine if it makes sense to "enrich" the job in a way that will justify a higher job value (do this only if truly legitimate)
- Take this opportunity to work with the employee to improve his/her performance to a level that would justify a higher "ideal" salary
- Transfer the employee to a higher graded job elsewhere in the organization, assuming he/she is qualified and interested

If all else fails and you feel you must continue the employee at a salary that is higher than justified by your guidelines, be sure to document the reasons for doing so.

This will help the organization in the event of a pay discrimination or wrongful termination lawsuit, and also provide a history and justification of the situation for managers who come after you.

Communicating the Approach

It is very important that clear, definitive communications be employed during both steps of this process. Terminology is critical. Refer to any salary increases as "adjustments" to avoid connecting them with what were probably called "merit increases" in the past. Merit increases in most peoples' minds are nothing more than entitlements.

If lump sum payments are made in lieu of increases, be sure not to call them “bonuses,” because a bonus payment connotes compensation that is tied specifically to performance.

It’s also important to communicate the reasons for any new salary administration practices, especially in cultures that were, over many years, entitlement-based.

Plan Maintenance Over Time

Once all employees are actually being paid their ideal amount, ongoing salary administration is a matter of making pay adjustments each year (we recommend focal point adjustments) consistent with each employee’s job value and performance.

The salary structure should be adjusted to reflect labor market inflation, and all employees whose job and performance have stayed the same will most likely receive an adjustment in an amount equal to the structure increase.

Take care not to convey this as either a general increase or a cost-of-living increase, for it is neither. If the job value changes or individual performance changes, the salary adjustment will reflect that.

Keep in mind, too, that out-of-cycle salary adjustments can and should be made to reflect such events as:

- New hires having become fully competent in performing their jobs
 - Significant performance improvements that appear to be long-lasting
 - Jobs being re-classified due to changes in level of responsibility, reporting relationships and or dramatic market changes.
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Success Factors

The success of this recommended approach depends on the ongoing maintenance and management of the following:

- Job description accuracy and completeness
- Continuing job evaluation and labor market research to reflect both internal and market changes as they occur
- Hiring practices consistent with the pay plan to avoid over- or under-paying new hires
- Performance measurement processes that are taken seriously and used as management tool
- Effective, repetitive communication of the salary administration policy and plan

Conclusion

In summary, employers who are serious about paying competitively, equitably, legally and cost-effectively will find that following these pay strategies and guidelines will not only result in meeting these goals, but will also enhance employee engagement and overall organizational success. While this is definitely not an easy process initially, your courage and determination will ultimately pay off!

About the Author

Upon receiving her B.A. degree in psychology from the University of California at Berkeley, Ms. Dunn headed to New York City to take a position in the human resources department of the Marine Midland Bank, and later worked at Nabisco in operations research. Returning to the S.F. Bay Area, she became a Research Associate for McKinsey & Co.



Next, she moved to Deloitte (then Touche Ross) as a consultant. It was at these two prominent consulting firms that she became knowledgeable about the challenges associated with paying employees effectively, and also gained high-level strategic consulting experience. Recognizing the additional value of applied corporate experience, she then spent the next ten years in compensation management positions with Fibreboard Corporation, Boise Cascade, Bank of America, and Castle & Cooke, where she worked both domestically and internationally.

In 1980, she established CompAnalysis, a consultancy dedicated to helping employers make successful compensation decisions. The firm has grown to become a leading S.F. Bay Area compensation management consulting firm, specializing in broad-based pay plans. The firm was acquired on December 21, 2010 by Arthur J. Gallagher & Co. (NYSE: AJG), an international insurance brokerage and risk management services firm, headquartered in Itasca, Illinois. CompAnalysis now provides compensation and human resources management consulting services as a division of Gallagher Benefit Services, an AJG subsidiary.

In addition to her management and consulting activities, Ms. Dunn is a well-known speaker and regularly leads seminars and workshops on employee compensation and related issues for a variety of audiences. She has published a number of articles and white papers, and also serves as an expert witness in connection with wage and hour litigation and other compensation matters.

She is the former President of the 5,000 + member Northern California Human Resources Association (NCHRA), one of the nations' largest chapters of the Society for Human Resources Management (SHRM). In addition, she maintains active memberships in the Bay Area Compensation Association and WorldatWork (formerly the American Compensation Association). She was formerly a member of the Women Presidents' Organization, the Executive Committee of the Board of Directors of the Oakland Metropolitan Chamber of Commerce, the California Alumni Association Personnel Advisory Committee, the Board of Directors of Easter Seals of the Bay Area, and a Director of the Haas Alumni Network of the School of Business at U.C. Berkeley, where she continues to serve as a guest lecturer.

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