

## Merit Planning

This lesson describes the merit planning processes. Specifically it addresses the merit planning process, gives a merit planning example, and provides a visual comparison.

Most companies use merit raises to reward performance by the professional workforce.

## Focused and Disbursed Merit Plans



The merit plan can be administered as a "focused" plan where all raises occur at the same time or as a "disbursed" plan where raises occur on employee's employment anniversary or according to merit plan algorithm. Corporate guidelines and regulations exist, for example, the minimum time between raises and the maximum raise percentage.

## Merit Planning Process

The typical process is the company determines total merit pool as a percentage of the total payroll. The merit pool is planned for distribution amongst employees based on relative salary and relative performance, which is often a computerized process or guidelines are provided. A report is produced for each supervisor indicating the recommended merit increase for his or her employees. The supervisor will review the computer-generated report and update it to reflect most current performance of his or her performance. If redlines total more than merit budget allocated to the supervisor, the supervisor must seek additional funds from the department manager. If the redlines total less, the supervisor returns funds to the department. The department manager must balance adjustments and then submit the modified plan to the administering organization. This process occurs annually, but most organizations allow for mid-year corrections.

## Relative Salary and Relative Performance

Large corporations usually subscribe to a salary survey service. Each subscriber provides salary information for applicable job families and levels and receives average salary information based on all submissions for job families and levels. Data can be requested for specific geographic regions and specific business domains, e.g., DoD contractors, Mid-Atlantic region, software engineers. The relative salary relates the average salary within a job family for a specific employee level as shown in the table.

**Job Family Average Salaries**

Level	Specifications	Software Engineer	System Administrator	Configuration Management	"xyz"
Associate	BS + 0 to 2 years	\$62K	\$50K	\$48K	Etc.

Engineer	BS + 2 to 5 years	\$73K	\$58K	\$55K	Etc.
Senior	BS + 5 to 10 years	\$85K	\$67K	\$63K	Etc.
Staff	BS + 10 to 15 years	\$100K	\$78K	\$74K	Etc.
Senior Staff	BS + 15 or more years	\$120K	\$92K	\$88K	Etc.

**Note 1: MS degree is equivalent to 2 years experience, e.g., engineer requires MS + 0 to 3 years**

**Note 2: Salary figures are fictitious**

Corporations can compare each employee to the industry average to determine their current "relative salary." For example, John Doe is a Senior Software Engineer currently earning \$82,000 per year. Based on the survey data, the industry average is \$85,000. John Doe is earning 96% of the industry average (\$82K / \$85K). Sally Smart is an Associate System Administrator earning \$54,000 per year. Based on the survey data, the industry average is \$50,000. Sally Smart is earning 108% of the industry average (\$54K / \$50K).

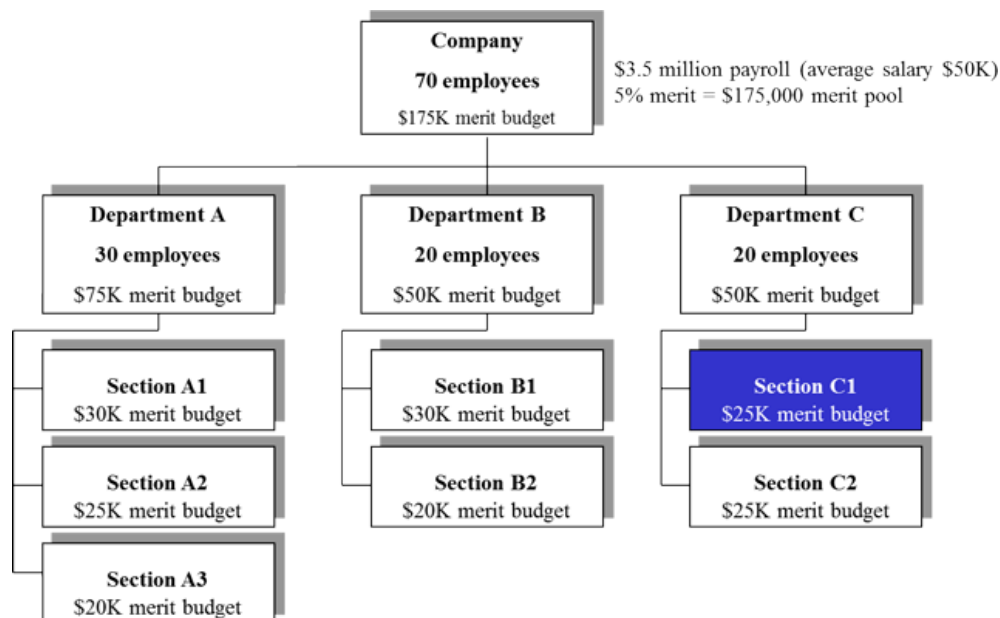
Salary consideration is not the only factor considered when determining merit increases. Companies also take into account its fringe benefits, which may include medical and group insurance, vacation and paid time off schedules, education benefits, retirement and pension plans, bonuses, and profit sharing. Also employee specific factors may play a part including type of education (what majors you have and where they are from), levels of education (what degrees you have), and years of work experience in this field.

Employees are ranked against their peers. The resulting ranking is broken into quartiles giving the relative performance. It is certainly possible for everyone in the organization to be rated highly yet when the ranking occurs, employees fall into all four quartiles.

Relative salary and relative performance are the primary inputs to recommended merit adjustments as shown in the table.

		Relative Salary			
		80% to 90%	90% to 100%	100% to 110%	110% to 120%
Relative Performance	1st Quarter	7% to 9%	6% to 8%	5% to 7%	4% to 6%
	2nd Quarter	6% to 8%	5% to 7%	4% to 6%	3% to 5%
	3rd Quarter	5% to 7%	4% to 6%	3% to 5%	2% to 4%
	4th Quarter	4% to 6%	3% to 5%	2% to 4%	1% to 3%

Each year this table is updated, based on cost of labor, inflation, and cost of living. The cost of labor is the cost of wages paid to workers plus taxes and benefits that is the cost of that employee as opposed to the cost of living is the cost of maintaining a certain standard of living. As an example, for a given employee whose relative salary is in the 95% and whose relative performance is in the 2nd quartile, the recommended salary increase using this table is 5 to 7%. You should note that as the relative salary increases over 100%, that is the employee is being paid more than the market bears the percentage of the merit planning increase decrease. Likewise as the employee's performance decreases, the merit planning decreases. In some organizations, the 4th quartile in relative performance and the 110% to 120% in relative salary are set to a 0% increase. Let's run through a merit planning example.



The company has 70 employees. The payroll is \$3.5M with an average salary of \$50K. The organization offers a 5% merit increase pool company wide. You will notice that some sections are allocated more or less merit budget. You are the manager of Section C1 and you are allocated a \$25,000 merit budget to be used for your 10 employees. The computer generated the proposed merit plan. You must redline the suggested plan and present your updates to your manager.

### Section C1 – Proposed Merit Plan

Name	Employee ID	Last Eval	2010 Salary	Relative Salary	Proposed Salary	% Increase	\$ Increase
A. Brown	018797	2nd	\$45K	115%	\$46.8K	4	\$1.8K
J. Gray	156432	2nd	\$55K	105%	\$57.8K	5	\$2.8K
C. Greene	224316	1st	\$65K	105%	\$68.9K	6	\$3.9K
K. Black	875465	2nd	\$40K	110%	\$41.6K	4	\$1.6K
C. White	154687	3rd	\$80K	105%	\$83.2K	4	\$3.2K
C. Mustard	387691	3rd	\$45K	95%	\$47.3K	5	\$2.3K
S. Peacock	202578	4th	\$40K	85%	\$42.0K	5	\$2.0K
J. Scarlett	443217	1st	\$40K	85%	\$43.2K	8	\$3.2K
R. Butler	489621	2nd	\$45K	95%	\$47.7K	6	\$2.7K
K. Wilkes	177843	4th	\$50K	105%	\$51.5K	3	\$1.5K
Totals			\$505K		\$530K		\$25.0K

2010 yearly payroll: \$505,000

2011 yearly payroll:  $\$505,000 \times 1.05 = \$530,250$  ( $\$530,000 - \$505,000 = \$25,000$  annual merit allocation)

You evaluate that C. Greene's performance since the recorded evaluation of 1st quarter has slipped to 2nd quarter. You revise recommended increase from 6% to 4% and the dollar increase from \$3900 to \$2600, thus returning \$1300 to the department.



C. Mustard's performance has improved drastically and Mustard completed the requirements for a Master's degree. You revise the recommended increase from 5% to 9% that is updating his salary increase from \$2300 to \$4050. This requires an additional \$1750.

The net effect of these redlines is you need (returned \$1300 - required \$1750) \$450 more dollars for the department's merit plan. As the supervisor of section C1, you must request and receive additional merit budget allocation from the C department. If you do not receive this additional funding, you will need to adjust your department's merit increase and shave off an additional \$450.

## Visual Comparisons

Visual comparisons can be useful to ensure you are properly rewarding your employees in terms of years of experience, education, and performance. In general, employees in the same job family who have more years of experience, higher education, and a higher performance rating relative to others in the company should be paid more.

It is easy to plot dollars earned each week but education and experience can be a challenge. Let's look at two employees: Employee A and Employee B as shown in the chart.

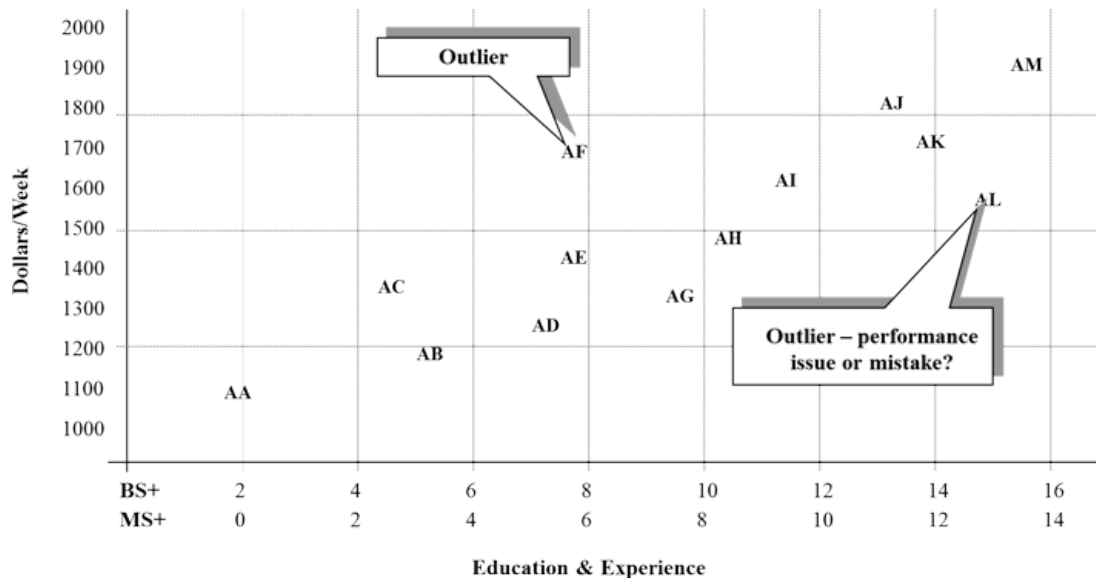
 <p>Employee A</p>	 <p>Employee B</p>
<p>10 years experience – 7 years in the Air Force, 3 years in the private sector</p>	<p>10 years experience – 5 years in the commercial sector, 5 years in the Aerospace/Defense Industry</p>
<p>BS in Computer Science with 3.6 GPA from ABC University</p>	<p>BS in Computer Science with 3.1 GPA from Carnegie Mellon University</p>
<p>BS in Computer Science with 2.9 GPA from XYZ University. Completed degree in 7 semesters and held part time job throughout.</p>	<p>BS in Computer Science with 3.3 GPA from XYZ University. Completed degree in 10 semesters, summer jobs only.</p>

**Comparing years of experience:** Employee A has 10 years of experience with seven years in the Air Force and three years in private sector, while Employee B who also has 10 years of experience but in different venues, 5 years in the commercial sector and five years in aerospace and defense industries. Both employees have 10 years of experience.

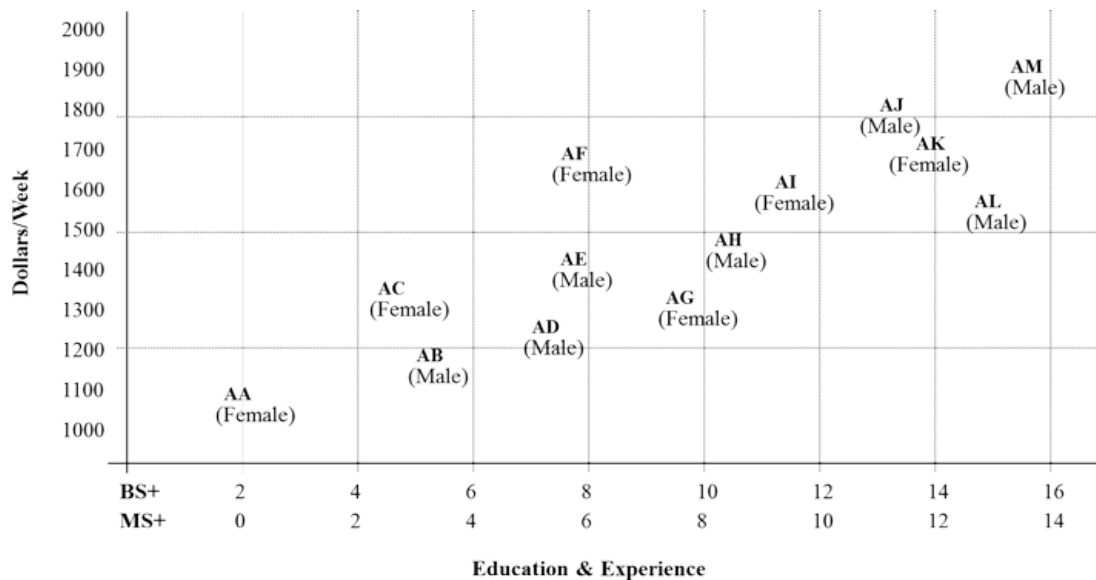
**Comparing universities and associated grade point averages (GPA):** When looking at Employee A, she has a BS degree with a high GPA from a mediocre university while Employee B has a lower GPA from an exceptional university. Both employees have solid degrees but their value to the organization may vary.

**Comparing activities throughout university and GPA:** Now let's assume both employees went to the same university, but Employee A finished the degree in seven months while holding a part-time job and Employee B took the "normal semester" load and worked only in the summer. Does it matter to your organization that Employee A earned a lower GPA? These facts must be considered when evaluating years of experience and level of education. It should also be noted that once in the job, informal on the job training can influence experience levels.

The chart below shows this visually. AF and AE have equivalent education and years of experience, yet AF is making \$300 more per week; it is important to justify and understand why AF is more highly compensated. Similarly it is important to understand why AL who has well over 12 years of experience is not being paid competitively with his or her peers namely AJ, AK, and AM. If you can justify these differences, there should be no problems. The issues occur when you cannot concretely justify the differences.



Other visual comparisons such as observing salaries for males versus females or race differences can ensure that you are paying your team fairly. Again it is not that these salary differences are not allowed; however, you must be able to justify why the differences exist. A senior manager or auditor may ask.



## Alternatives to Merit Increases

Some organizations use other methods of increasing salary including profit sharing, bonus programs, or improved fringe benefits. Let's examine the advantages and disadvantages. A bonus program or profit sharing looks attractive. Who would not want a lump sum increase? It can motivate employees' performance, it does not affect company rates, and company performance determines the bonus, but it does not improve your pension or salary-matching program such as the 401K, so it is not part of your

base salary. Lastly it is highly dependent on the company's performance not your individual performance. Given a choice of a lump sum salary increase or a merit based salary increase of the same amount, it is generally better to take the merit increase since it increases your base salary. Of course if the comparison is not equal, then the bonus or profit sharing can be extremely lucrative. Look at those individuals who were at AOL or Microsoft at the right time and became multimillionaires almost overnight!

Fringe benefit increases are low in cost to administer and offer a big bang for the buck with group rates but it offers less control for individual employees and is difficult to base on performance. The table below summarizes these differences.



	Advantages	Disadvantages
<b>Bonus Program</b>	<ul style="list-style-type: none"> <li>• Lump sum looks attractive</li> <li>• Motivates employee performance</li> <li>• Does not affect company rates</li> <li>• Is determined by company performance</li> </ul>	<ul style="list-style-type: none"> <li>• Does not improve pension or salary matching programs (e.g., 401K)</li> <li>• Weighs heavily on company performance</li> </ul>
<b>Fringe Benefits</b>	<ul style="list-style-type: none"> <li>• More bang for the buck by obtaining group rates</li> <li>• Minimal cost to administer</li> </ul>	<ul style="list-style-type: none"> <li>• Less control for individual employees</li> <li>• Difficult to base on performance</li> </ul>

This next table shows the effect of multipliers on salary and rates. Here we show three fictitious companies: a large, a medium and a small sized contractor each with annual salary, hourly rates, fringe, overhead, G&A, and the loaded or fully burdened rate that is charged to the customer. As you examine the table below you will see that changes to each of these multipliers can significantly impact the loaded rate. For example, an employee making \$75,000 at a small company may have a loaded rate of just \$61.33 whereas at a large company, it may be able to charge a loaded rate of \$76.39 for a similar employee. Fringe benefits are usually lower at a large company since it can obtain better group rates, but overhead and G&A are more expensive at large companies.

Typical large size contractor with significant overhead and G&A					
Avg Annual Salary	Hourly Rate	Fringe	Overhead	G&A	Loaded Rate
75,000	36.06	0.32	0.5	0.07	76.39
Typical medium sized contractor with moderate overhead and G&A					
Avg Annual Salary	Hourly Rate	Fringe	Overhead	G&A	Loaded Rate
75,000	36.06	0.4	0.25	0.05	66.26
80,000	38.46	0.4	0.25	0.05	70.67
86,500	41.59	0.4	0.25	0.05	76.42
Typical small sized contractor with minimum overhead and G&A					
Avg Annual Salary	Hourly Rate	Fringe	Overhead	G&A	Loaded Rate
75,000	36.06	0.45	0.15	0.02	61.33
80,000	38.46	0.45	0.15	0.02	65.42
85,000	40.87	0.45	0.15	0.02	69.51
93,400	44.90	0.45	0.15	0.02	76.37

**Note:** multiplier differences exaggerated to emphasis the point

## Conclusion/Summary

In summary, the merit planning process is significant in how it is approached, planned, and implemented. Every employee is affected either positively or negatively. It is important to implement your merit planning program consistently and fairly.