



Harry Franzheim—an HR/OD Practitioner for over 30 years—has published this newsletter to bring you careful insight into reducing costs and unlocking employee potential.

AT ISSUE

The typical annual wage increase is too small for employees, and the automatic pay increase for all employees is too much for many employers. What to do? Replace it with a variable pay program.

The Annual Pay Raise: Why It Needs to Die



HR Fact:

Slow Rise of Wages, What's Going On?

Standard economic theory teaches us that wages usually stagnate when unemployment goes up, and conversely wages usually rise when unemployment goes down.

So why have wages been rising so slowly during our current economic recovery with unemployment hovering around only 5%? Two reasons:

- 1) The entry of low-wage workers to full-time jobs.
- 2) The exit of higher-wage retirees.

This combination of factors has turned standard economic theory on its head.

Recent articles from the *Washington Post* and the Society for Human Resource Management reflect a 2017 trend of companies looking to do away with the automatic annual pay increase. They cite the belief that the typical 3% increase is too small to have an economic impact for the employee, yet it's a significant cost increase to the employer—especially when a 3% increase happens every year. This creates an entitlement mentality for the employees and a labor cost burden for the employer. In our Winter 2013 issue, we warned about this and offered some suggestions for creating a sustainable pay system that works for both employees and the employer. In this article, we want to zoom in on our variable pay plan and offer easy steps to implement one on your own.

Test Question: What Is the Sole Purpose of a Compensation System?

The sole purpose of a compensation

“The sole purpose of a compensation system is to attract and retain the talented employees needed to accomplish the goals and achieve the results of the organization. Period. End of story.”

DOWN WITH ANNUAL REVIEWS AND ANNUAL INCREASES



UP WITH VARIABLE PAY TIED TO BUSINESS PERFORMANCE

system is to attract and retain the talented employees needed to accomplish the goals and achieve the results of the organization. Period. End of story. We have already written about the perils of incentive compensation and other pay gimmicks intended to “bring out the best in people,” and we know that good people will do dumb things when incentivized to do so. Recall our recent article about Wells Fargo and the “Great Eight.” HR and other executives seem all too eager to abdicate their responsibility to act as inspiring leaders by simply installing incentive programs to motivate the troops. Puppy dogs and some cats will fall for that trick, and some humans don't mind the extra credit for beating up on a co-worker on a project, but they know in their hearts that it is wrong. Sure, employees that contribute more value to the organization may receive a different pay grade than

one that does not, but that distinction was already evident in the employment market. We had to pay \$\$\$\$ to get this employee on board, but we had to pay \$\$\$\$\$\$ to get this other employee on board. Are employees leaving the company for higher-paying jobs doing essentially the same basic work as they were with our firm? If so, then the pay is wrong. Adjust it. But don't wait for employees to leave to make sanity adjustments. Conduct salary surveys from time to time to verify that the pay is competitive.

Dump the Annual Review and Dump the Annual Increase With It!

It is amazing to me how much more frequently I am hearing that the annual review should be killed and replaced with more frequent, informal feedback from peers or mentors. We have been saying this for years. The opposition to dumping the annual review would say that you have to do the annual review to justify the annual merit increase. Dump them both, problem solved! That alone will save a company lots of time, money, anxiety, and game playing. What to do instead?

Variable Pay Is the Solution!

Variable pay is compensation that varies from period to period (as opposed to salary that is a constant drip, drip, drip) and can range from small amounts to large amounts depending on the performance of the criteria within the plan design. Criteria that is tied to business performance is best, as long as the employees can adequately impact the criteria. We use a criteria called Employee Controlled Profit Share Program. To be clearer, we use the top line (revenue) minus expenses (profits), but we include only the expenses that our employees have control over. Our employees have no control over the business owner's she-nanigans like our auto leases, fuel, and the like, so those kinds of expenses are not included. What are included are the expenses that the employees have some control over. Once we have determined the Em-



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SURVEY



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With the variable pay program, you can blow up the annual merit increase right along with the annual performance review, maintain competitiveness in your ability to attract and retain employees, and keep compensation costs under control.



A variable pay system shifts the focus from "getting a raise" to "earning a bonus."

ployee Controlled Profits (ECP), we then factor the profit so that we don't give it all away! We multiply the ECP by .04 or 4%. This gives us the total amount to be paid out for the period. However, to determine the variable pay amount per employee, we take the ECP and divide it by the total salaries paid to the eligible employees for the period. That yields a number that ranges between 4% and 20%. The employee share is their individual, actual salary multiplied by the 4-20% result.

Our Plan Is Quarterly

Our variable pay plan is a quarterly plan that offers variable pay opportunities four times per year. In the fourth quarter, however, we let October and November stand alone so there is a variable pay opportunity before the holiday season, and we let December stand alone so there is another variable pay opportunity after the holiday season.

Variable Plan Eliminates Annual Increase and Review

By using a variable pay program, we can blow up the annual merit increase right along with the annual performance review, maintain competitiveness in our ability to attract and retain employees, and keep compensation costs under control. Gone are the days when our salary costs increased 3-4% per year, every year into perpetuity.

Employees as Owners

We want our employees to think and act like business owners. We despise entitlement mentality and simply cannot afford yearly annuities in the form of annual salary increases. A variable pay system shifts the focus from "getting a raise" to "earning a bonus." As business owners it makes us very proud to see our employees earn a living. **ne**



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