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2005 Michigan Manufacturer of the Year Award Recipients p. 10

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Compensation in Michigan Manufacturing Rebounds

By Edmund B. Ura

After falling to the lowest levels in 15 years in 2004, the average increase in labor rates for both base pay and total cash compensation bounced back sharply, and incentive compensation payments fueled the changes.

While still trending downward, companies are also planning increases of at least the same level as last year for 2005.

This good news for employees, and many other findings, can be found in the results of the recently published *2005 Compensation in Michigan Survey™ – Manufacturing Edition*, sponsored by the Michigan Manufacturers Association (MMA) and conducted by Plymouth-based consulting firm Management Resource Center, Inc. (MRC).

Nearly two-thirds of Michigan manufacturing employees will be eligible to receive some type of incentive payment in 2005, making it crucial to understand the difference between compensation statistics. "Base pay" is simply what it appears to be, either the annual salary or quoted hourly rate. "Total cash compensation" is a measure similar to W-2 earnings — it includes the current year annualized compensation and incentive payments earned in the prior year.

With incentive payments being made to more employees, and making up a larger part of their compensation package, Michigan manufacturers must adjust their sights to ensure they remain competitive. It is no longer enough to look at base pay, whether the hourly rate or an annualized salary. To be fully competitive, companies must take one of two approaches — be competitive on base pay and have a competitive incentive program or adjust their base pay to match competitive total cash compensation.

Measuring change is a challenge

There are a number of ways to describe year-to-year changes in compensation, all of which have their strengths and weaknesses. Most of these methods fall into one of two categories: 1. Reporting on what companies did (or will do), and 2. Reporting on the actual rates paid in the labor market as a whole. *The Compensation in Michigan – Manufacturing Edition* provides guidance and insight into change using both these methods.

Manufacturers' pay increase programs on a downward trend

Michigan manufacturers spent less on pay increases again in 2004 and all signs point to a continuation of that trend for the upcoming year. Total increases to employee base pay in 2004 were slightly above three percent, down from an average of more than four percent in 2000, and sharply down from 2003, which saw the highest reported increases this decade. With the exception of 2003, average pay increases have steadily declined, as illustrated in Figure 1.

Figure 1 provides insight into the way manufacturers are responding to changes to the economy and their own business conditions.

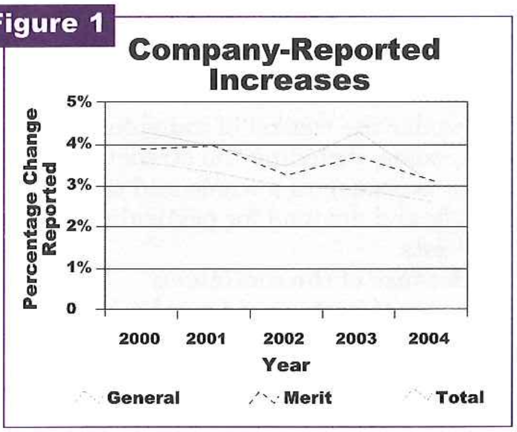
General increases, those which are given to employees "across-the-board" regardless of individual performance, are decreasing in popularity (less than 20 percent currently use this method) and in amount. The average general increase expenditure has declined by nearly a third, from about 3.7 to 2.6 percent, over the last five years.

The general increase approach, which is often used to "keep employees whole" and is based on a measure of inflation such as the Consumer Price Index, has clearly lost its appeal to business owners and is likely to be seen most often in companies with union contracts.

Clearly replacing the general increase approach is the use of at least some form of merit pay. While methods vary, the idea, at a minimum, is to provide increases that relate in some way to the contribution an individual employee makes to the company. Merit increase programs are also likely to be based on the ability of the company to adjust pay, as they are not tied to government-provided statistics.

When looking at survey information on company plans and performance, it is important to compare apples to apples. This is clearly the case when looking at this year's survey.

Figure 1



Comparing 2005 projections to 2004 actual statistics might lead to the conclusion that companies are expecting to spend more — after all, total budgets for increases planned for 2005 are at 3.3 percent, higher than the 3.1 percent actual budget increase reported for 2004.

The true comparison is not "actual to planned," but "planned to planned." When looking at the 2004 report, it is clear that budgeting for 2005 is the same as for 2004.

Why the difference between budget and actual data? Employers almost never actually spend as much as they budget. Budgets are generally based on the payroll in effect at the time of the budget process and, in most cases, do not take into account that payroll decreases during the year when long-service, higher-paid employees retire or are promoted and are replaced by lower-paid individuals.

The effect is multiplied by the fact that these new employees are often not eligible for increases during the year. The bottom line is that actual reported changes to payroll are consistently one-quarter to one-half percent lower than what was projected.

Measuring "actual" change in the market

Using the "company plan" approach to measuring market change is problematic in that it only deals with a small part of the market — the companies that are reporting increases. The "market" is driven by a host of other factors not under the control of individual companies, including the strength of the economy as a whole and the supply and demand for particular skill sets.

Because of the continuous turnover of higher-paid employees due to retirement and, in recent years, to layoffs and company bankruptcies the rate of actual change to pay rates is considerably lower than what companies report as their programs. While the "average" pay increase program over the last 10 years has generated a four percent increase to base pay, the historic "actual" average increase in the market has been about three percent.

Companies that consistently increase their payrolls based on budgets are likely to find themselves paying more than is necessary to attract and retain the talent needed to be successful.

To measure change in the market, MRC uses an average of the year-to-year increases found in a group of key jobs. Because of changes to the survey itself and a shift in what jobs are considered "key" (those that have the highest level of response to the survey), a new methodology was developed for this article.

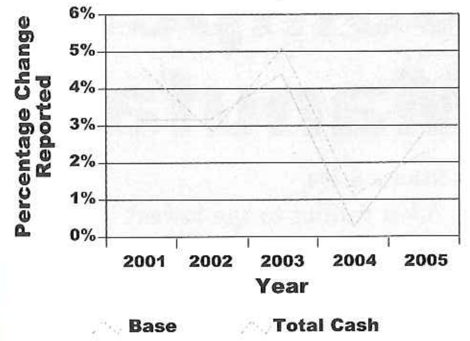
Using information on 80 jobs from the survey, Figure 2 illustrates how the average increase to base pay and total cash compensation has changed over the last five years.

Although more difficult to see in Figure 2, the trend in actual pay increases in the market has been a downward one. The rebound from 2004, while good news in some ways, still returns pay increases only to a place on a declining trend.

Reconciling the two methods is more difficult, but the end result is the same — whether through measuring company planning or actual market change, the trend for base pay increases is downward. Company planning charts show a steadier decline, while the actual rate charts are more erratic but pointed in the same direction. Both methods show the sharp increase in 2003, when companies provided the highest level of base pay increase to their employees.

Figure 2

Base Pay and Total Compensation in the Market



Total Cash Compensation Fuels the Rebound

While Michigan manufacturers may be slowing the growth of pay, they are providing opportunities for total "take-home" compensation to increase through the use of incentive compensation programs. Incentive compensation programs, when properly designed, give the employer the opportunity to reward performance in the year it occurs and link costs to income and profitability more effectively.

Nearly two-thirds of Michigan manufacturing employees will be eligible to receive some type of incentive payment in 2005. About two-thirds of the employees who were "bonus eligible" in 2004 actually earned a payment, a number which represents about 42 percent of all employees.

For most jobs, the actual incentive amount, as a percent of base pay, more than doubled from the prior year, resulting in one of the few years in which total cash compensation increased at a rate higher than base pay.

Suggestions for Comp Planning in 2005

There are two main findings of the survey that suggest directions Michigan manufacturers should pursue — formalizing compensation programs and designing and implementing effective incentive compensation programs.

Participants reported more information on formal programs — range midpoints and hourly top rates — than in any prior year. While part of this can be attributed to the addition of larger employers, much of it points to the simple fact that compensation can best be controlled in the context of a formal plan.

Formal programs, with established pay ranges tied to the value of a job to the company and in the market, allow more control over a significant part of any manufacturer's budget.

Plans for moving new employees up in the range help reduce turnover and related costs, and limits on the top end of a range keep pay growth from creeping to the point where employers are paying much more value than they receive.

The purpose of an effective incentive program is to ensure that employees are motivated toward behaviors that the employer believes will eventually optimize profitability. This type of plan can result in dramatic long-term savings. Base pay increases can be limited and the "variable" part of compensation can be tied to the company's actual performance and its ability to pay. The survey results suggest that the mix of pay has been moving in this direction.

Whether or not an employer plans on exploring either of these possible changes to their approach to compensation, they must realize that they exist, and plan accordingly.

The increasing effort to manage pay through formal approaches will make companies more effective in their recruiting efforts and place those without such approaches at a disadvantage. Those employers not embracing an incentive compensation approach must understand that most of its competition does so and, when setting total compensation objectives, must look at total cash compensation as much as base rates in order to be competitive.

How the 2005 Edition Adds Value

Since the Compensation in Michigan survey program was redesigned in 2003, it has become more attractive to larger employers, which make up the highest percentage of participants in several years.

Increasingly, the participant mix better represents the Michigan economy and the data reported includes an increasing number of actual employee's pay. This is good for larger employers, who benefit from data more valuable to them and for smaller employers who get the opportunity to see a picture of the bigger market.

The survey's use of revenue groups ensures, however, that regardless of a company's size, it can compare itself to a group of true peers.

Specific detailed information, including breakouts by region, industry and revenue, is available now for 167 jobs, the most ever in the program. Larger employers can now see some of the distinctions made between different "levels" of various professional positions and, for some jobs, distinctions are made between the complexity of the operations. Once again, these changes add value to all participants, as well as those who purchase the report.

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