

H. C. FOSTER & COMPANY

Retirement and Welfare Plan Actuaries

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Balancing Compensation Costs – Winter 2014 and 2015

Employers tend to view pension and welfare plan benefits costs as added costs rather than as an integral part of an employee's commercial value. One consequence is a growing number of longer-service employees have little hope of meaningful pension benefits when they retire, so may cling to their jobs beyond productive years. Defined benefit plans covered only about 18% of workers in 2013.

A strategic way to evaluate a compensation package is to work backwards from an employee's "commercial value". Following is how a structured compensation package would appear for a 45 year old, non-union employee having a commercial value of \$70,649 with a 2,000 hour year:

	Total	%	Hourly
Incentive bonus assuming performance goals attained, paid monthly	\$12,500		\$ 6.250
Annual base compensation rate exclusive of performance bonus	34,250		17.125
Paid leave exclusive of performance bonus to total \$50,000 Form W-2, 4.6%	3,250	70.8%	1.625
Group insurance, includes life, disability, and health insurance with ACA, 8.2%	5,793		2.897
Legally required benefit, e.g., Social Security, ACA, unemployment, 10.0%	7,065		3.532
Administrative costs allocated as percentage of Total Compensation, 1.5%	1,060		.530
Defined benefit plan allocated cost for \$2,000 monthly pension at age 65	6,731	29.2%	3.365
Total:	<u>\$70,649</u>	100.0%	<u>\$35.324</u>

The commercial value less the total costs for pension and welfare benefits, including legally required benefits and administrative costs equals the Form W-2 wage rate of \$50,000; \$70,649 less \$20,649 equals \$50,000. This procedure nets all benefit costs to zero (\$-0-) as compared to an added cost for benefits.

Determining an employee's "commercial value" for the starting point of the calculation differs for each employer and employee depending on the industry and many other factors beyond the scope of this presentation. This employee expects annual Form W-2 wages of \$50,000 with full welfare plan benefits, and pension benefits of \$2,000 per month beginning at age 65. An employee not willing to accept Form W-2 wages that support his commercial value after his pension and welfare benefit costs will not remain with the employer if he finds other work that pays higher direct compensation wages that will be with reduced benefits unless his commercial value is greater to another employer.

Most data for the above calculations for each employee appears in the end-of-year payroll records the accountant develops for payroll reporting. Most employers and employees do not realize total compensations range from 120% to 140% of Form W-2 direct compensation wages. Comprehensive benefits statements can be prepared from the above results for employees to apprise employees of their "hidden paycheck" values.

Several factors enter the above calculations, including the following:

1. The non-direct compensation cost percentages are from the Bureau of Labor Statistics (BLS), and vary by industry and employee classification. Total pension and welfare compensation costs of 29.2% exceed BLS averages, but the employee is credited pension benefits in lieu of taxable compensation. The \$2,000 pension objective will increase with salary increases to offset loss of purchasing power through monetary inflation; and, non-pension ancillary benefit percentages decrease with compensation increases. Allocated pension costs depend on the plan in effect and its benefit formula.

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2. Annual pension cost is for a single life annuity at age 65 paid directly from an employer-administered plan that avoids the need to purchase insurance company life annuity contracts. A Lump Sum Distribution option is not permitted because it could be extremely costly, and death benefits are limited to the ERISA required surviving spouse 50% life annuities. Actuarial assumptions are 6.0% annually compounded interest and a 2014 PPA '06 Mortality Table for level funding costs over 20 years. Annual minimum funding costs under PPA '06 may vary dramatically from the actual level funding cost for pension benefits. Employer administration of investment management and daily administrative functions avoids hidden administrative and investment management costs.
3. The above analysis for each current employee's actual compensation costs will expose flaws in the employer's compensation program. An employer can reduce his total compensation costs significantly through this process. See our Spring 2014 Newsletter for ways to reduce pension costs through Social Security offsets, Floor-Offset plans, and other plan design options. The employee's value of compensation deferred through a pension plan averages about 130% more than direct compensation due to tax and Social Security withholding reductions, and is less costly to the employer because Social Security matching and ancillary benefits costs tied to direct compensation are avoided.
4. A 45 year old private sector worker earning \$50,000 per year will need at least \$2,000 per month at age 65 in today's dollars as a single life annuity to sufficiently supplement his Social Security retirement income. He will need \$2,972 per month at age 65 to retain today's purchasing power with annual 2.0% inflationary price increases, \$2,000 times 1.02^{20} . Assuming 6.0% annually compounded investment returns, this equates to an account balance of approximately \$468,000 at age 65 for 25 years' payments. 6.0% is a projected long-term weighted average investment return rate.
5. Many employers sponsor Section 401(k) plans that require employee voluntary contributions to qualify for tentative employer matching contributions that may be in company stock. The ICI Research Perspective last updated on the Internet during December 2014 for the 2013 calendar year shows average Section 401(k) account balances by age and employment service in Exhibit 13. It shows workers in their age 40s with 10 to 20 years experience having average account balances of \$109,257, with the age 50s group with 20 to 30 years experience with average account balances of \$211,424. These employee groups are unlikely to accumulate \$468,000 in retirement savings by age 65. Risks include: (a) inconsistent investment returns; (b) inability and lack of resolve to contribute to an account balance plan year after year and preserve account balances for retirement purposes, leakage from Section 401(k) accounts is estimated at 25% in a recent WJS article; and, (c) longevity in retirement exceeding account balance payments.

Employers are deferring additional benefit plan costs in the face of uncertain costs and penalties under the Affordable Care Act (ACA). Recruiting opportunities exist for employers offering full employer-paid pension and welfare plan coverages to obtain experienced, productive employees. Experienced, longer-service employees return the most revenue per compensation dollar. Responsible employees will welcome employment that provides pension benefits; and, with proper communications, will understand the employer's pension cost replaces taxable direct compensation.

A note regarding mandatory pension coverage discussed in our Fall 2014 Newsletter - prior Illinois Governor Pat Quinn signed the Illinois Secure Choice Savings Program Act (S.B. 2758) into (State of Illinois) law on January 4, 2015 to require a USA Funds type mandated retirement plan coverage. We hope the new Governor can rescind this mandate on employers if not already rescinded.

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