

# *FEDERAL HOUSING FINANCE BOARD*



## *AUDIT REPORT*

MERIT PAY INCREASE PROCEDURES

REPORT NUMBER: 08-A-03-OM

*Prepared by the*

OFFICE OF INSPECTOR GENERAL

*EDWARD KELLEY  
INSPECTOR GENERAL*

### **NOTICE OF SUBSEQUENT EVENTS**

**On July 30, 2008 and after substantial completion of this audit, the President signed the “Housing and Economic Recovery Act of 2008” (ACT). The Act gives the Finance Board responsibility for winding up the affairs of the Federal Housing Finance Board (FHFB) by July 30, 2009. Consequently, recommendations in this report that relate to matters associated with winding up the affairs of FHFB will be forwarded to the Chairman of FHFB for action under the authorities delegated to him by the Federal Housing Finance Board.**

# *FEDERAL HOUSING FINANCE BOARD*



## *AUDIT REPORT*

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**AUDIT REPORT**  
Office of Inspector General  
FEDERAL HOUSING FINANCE BOARD

Issue Date September 22, 2008
Report Number: 08-A-03-OM

**MEMORANDUM**

**TO:** David Lee  
Director, Office of Management

**FROM:** Edward Kelley  
Inspector General

**SUBJECT:** OIG Audit Report on Federal Housing Finance Board's (Finance Board's) Merit Pay Increase Procedures

**EXECUTIVE SUMMARY**

The Federal Housing Finance Board (Finance Board) is responsible for establishing and directing policies and procedures for compensating agency employees. We believe that a critical factor in the Finance Board accomplishing this responsibility rests upon the adequacy of the agency's policies and procedures for determining and implementing annual merit pay increases. We have completed our audit of this area for the FY 2005, FY 2006 and FY 2007 calendar years. Our audit was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) issued by the Comptroller General of the United States. The objective of our audit was to assess the adequacy of Finance Board policies and procedures for determining annual merit pay increases and the Finance Board's implementation of the policies and procedures.

We found that overall the agency's process for awarding merit pay increases was reasonable; however, the process needs to be changed to ensure employees can receive fair and comparable merit pay increases regardless of whether they are in an office with many employees or one with few employees and to ensure that the policies and procedures are consistently applied to all Finance Board offices by OM. We also found that merit pay increases were usually accurately calculated; however, because of a lack of adequate internal operating procedures, we found instances of merit pool calculation errors, errors in calculating merit pay increases, and instances where employee merit increase calculations were not

adequately documented. The inaccurate calculations went undetected and were not caught by the Office of Management (OM) and impacted the amount actually paid employees.

### Recommendations

We recommend that the Chairman approve a change to the compensation policies and procedures to allow Office Directors to request the Chairman's approval for increases to the currently computed merit increase pools, in order to provide managers greater flexibility and to help facilitate a more fair and equitable compensation process.

We also recommend that the Director of OM:

- 1) circulate all current merit pay increase policies and procedures and policy changes (including "pen and ink" changes), to the Board members and agency Office Directors for review and comment before finalizing and updating agency policies;
- 2) make all HR policies available to all agency employees electronically on the agency's website, which would allow agency employees to review policy practices at their own liberty. Further, all policy changes should be updated, announced to all employees, and posted electronically within 60-90 days of approval.
- 3) develop and implement internal operating procedures that clearly assign responsibility to a position or person for verifying merit increase calculations before they are input into the NFC payroll system and for verifying NFC output information on Finance Board merit pay increases;
- 4) propose revisions to the merit increase policies and procedures before the next merit increase process, to clearly explain how merit pay increases are calculated and to require that Office Directors or their designees explain to each employee how their merit increase was calculated; and
- 5) develop and implement internal operating procedures that require all personnel changes (including corrections in employee compensation), be properly documented and supported in the OPF files.

The Counsel to the Chairman disagreed with our recommendation. He indicated that since no director has complained about the current policy, he prefers to keep the policy as it is now. Additionally, he noted that since the Finance Board is such a small agency, that any office director can easily appeal an OM decision directly to the Chairman. We do not agree with management's position because it does not address the deficiency noted during our audit. Specifically, in the absence of better controls, OM, the office responsible for processing merit increases, violated the agency's policy limiting merit increases and the violation went undetected until our audit. The current policy does not address this problem.

The OM Director was unwilling to provide comments on the accuracy of the report and on any corrective actions taken to address the report recommendations. He does commit to considering our recommendations in the creation of a new compensation policy for the Federal Housing Finance Administration (see Appendix 2). However, we believe these recommendations should also be considered in preparing the Finance Board's Fiscal Year 2008 merit pay increases.

## INTRODUCTION

We have completed an audit of the Federal Housing Finance Board's Merit Pay Increase Process. Our audit was conducted in compliance with Generally Accepted Government Auditing Standards (GAGAS) and issued by the Comptroller General of the United States. The objectives of our audit were to assess the reasonableness of the merit pay increase process and the accuracy of merit pay increase computations.

We found that overall the agency's process for awarding merit pay increases was reasonable; however, the process needs to be changed to ensure employees can receive fair and comparable merit pay increases regardless of whether they are in an office with many employees or one with few employees and to ensure that the policies and procedures are consistently applied to all Finance Board offices by OM. We also found that merit pay increases were usually accurately calculated; however, because of a lack of adequate internal operating procedures, we found instances of merit pool calculation errors, errors in calculating merit pay increases, and instances where employee merit increase calculations were not adequately documented. The inaccurate calculations went undetected and were not caught by the Office of Management (OM) and impacted the amount actually paid employees.

## SCOPE

To accomplish our audit objectives, we identified and reviewed relevant federal laws, regulations and guidance related to merit pay increase. We also reviewed Finance Board policies and procedures governing the agency's merit pay increase process. We reviewed annual merit pay increases for 2005 through 2007 to assess the accuracy of the calculations. We flowcharted the merit increase process to identify potential internal control risks. Finally, we conducted interviews with agency managers and staff regarding the procedures for determining annual merit pay increases and the Finance Board's implementation of the policies and procedures.

## BACKGROUND

The Finance Board is responsible for establishing and implementing policies and procedures for compensating agency employees. The agency has adopted written compensation policies and procedures and implemented a process for facilitating annual merit pay increases for all Finance Board employees. Details of the merit pay process are included in Attachment 1.

The Office of Management (OM) is responsible for managing the merit pay increase process at the Finance Board. Specifically, OM is responsible for developing and implementing policies and procedures related to the merit increase process that are fair and compliant with federal laws and regulations and for maintaining a system of internal controls to ensure that these policies and procedures are consistently implemented. OM accomplishes its responsibilities with full time permanent staff and the periodic use of contractor personnel specialists. From FY 2005 through FY 2007, OM outsourced its accounting and

payroll/personnel data input functions to the U.S. Department of Treasury's Bureau of Public Debt (BPD) Administrative Resource Center (ARC). The payroll/personnel data system is managed by the National Finance Center (NFC).

## **FINDINGS AND RECOMMENDATIONS**

### **NEED FOR BETTER AGENCY-WIDE MERIT PAY POLICIES AND PROCEDURES AND BETTER OM OPERATING PROCEDURES**

We believe that internal controls for the merit pay increase process should ensure that responsibilities assigned to the agency offices and personnel are performed fairly, consistently, effectively, efficiently, and economically and result in the accurate calculation of merit pay increases. Current agency-wide policies and procedures do not facilitate fair and consistent merit pay actions. In addition, Office of Management's (OM) internal operating procedures were not developed, documented, and distributed to OM staff to ensure that each person understood their respective duties, accountability was established, and processing duties were not inadvertently neglected - especially when there are staffing changes.

#### **Changes to Agency-wide Compensation Policies And Procedures Are Not Properly Distributed to Facilitate Office Directors' and Employees' Verification of The Merit Pay Increases And the Full Use of Compensation Incentives Available**

For offices that provide agency-wide services, current agency-wide policies and procedures should be developed and distributed to all agency employees to help clarify what employee expectations should be and to facilitate employees' feedback on services received. For example, the ultimate internal control in the merit increase process results from payees' verification of their merit increase computation. In order for this control to work properly, clear and complete policies and procedures describing the merit increase process should be developed and distributed to all Finance Board staff. These policies and procedures would also help managers to more thoroughly understand and fully utilize the compensation process to properly compensate staff performance.

Written policies and procedures should be developed, reviewed by stakeholders, and properly implemented to ensure consistency in operations. A key element of any implementation strategy should be the distribution of policies and procedures to all stakeholders to facilitate their understanding and compliance. However, we found that prior to the initiation of our audit, compensation program policy revisions were not consistently circulated to Office Directors for comments nor were they circulated to staff for their information. As a result, 1) written agency-wide compensation policies and procedures lacked proper vetting and adequate details to ensure stakeholders' concerns were properly addressed; and 2) agency employees were not provided adequate information to verify merit increase calculations.

*Written Agency-wide Compensation Policies and Procedures Lacked Proper Vetting  
And Adequate Details to Ensure Stakeholders' Concerns Were Properly Addressed*

We found that the revised compensation policies and procedures did not provide a clear and complete explanation of how merit pay increases are processed. Specifically, the policy does not include a sample Merit Increase Certification Sheet (MICS) with information on how the annual compensation is computed. The policy also does not include information such as: the difference between the terms "salary" vs. "pay." For instance, the policy is unclear on how the base salary differs from the base pay, and on how the lump sum merit pay will never be included in an employee's base pay or used to determine future merit increases. The policy is also unclear on the merit increase percentage ranges for each rating, and it does not explain how the *Finance Board "Performance Rating Form,"* completed for each employee impacts the annual merit increase determination process. Further, none of the revised policies and procedures required Office Directors to explain to each employee how their merit pay increases were calculated.

The Deputy Director advised that the Compensation Program policy was not intended to include the compensation worksheet and instructions. Per the Management Analyst, OM did not receive any terminology inquiries when the spreadsheets were distributed. The Deputy Director advised that section XIII in the Compensation Program policy adequately explains the application of the lump-sum merit pay and that it is up to the Office Directors to decide whether to share merit percentage rating ranges with their staff. Per the Deputy Director, an explanation of the impact of the Performance Rating Form is not necessary, as the Performance Management Program policy provides reference to this matter. He considers these two separate matters and advised that the Compensation Program policy provides reference to the rating and that is adequate. We found that while paragraph 1-E of the Performance Management Program (PMP) as of July 28, 1999, indicates that performance ratings are used for determining merit increases; the Compensation Program policy only makes reference to a rating of record, and does not provide a connection for employees to associate it with the PMP policy.

For the period we reviewed, we found no evidence that changes to the compensation policies and procedures were consistently circulated to Office Directors for comment. Although some compensation-related policy changes did not impact the merit pay process, some policy changes resulted in restricting rather than increasing the available incentives that Office Directors could use for recruitment and retention. This occurred at a time when the Finance Board's emphasis was on providing more employee incentives. Specifically, in the absence of vetting by Office Directors, compensation policies and procedures were changed as follows:

1. An employee with a performance appraisal lower than another employee in the same office, may be authorized a merit pay percentage increase larger than the employee with the higher performance appraisal. For example, an employee with a Fully Successful appraisal could receive a 5 percent merit increase, while an employee in the same office could receive an Outstanding appraisal and only receive a 4 percent merit pay increase. Per the Deputy Director, prior to this change, there were restricted and separate merit increase percentage ranges for each individual performance rating. The change extends the ranges of the performance rating into the next higher performance rating, thereby allowing supervisors to award high performers with a higher percentage rating.



2. The amount of promotional pay increase was raised from 8 percent of an employee's base pay to 10 percent of an employee's base pay.
3. The salary level of appointments by initial hire, reinstatement, or transfer is set at no more than 10 percent over the employee's highest previous rate unless it is required to be higher to meet the minimum salary for that grade position. Any requests to set salaries for initial hires, reinstated employees, transferred employees, and promoted employees must at least equal the minimum salary of the grade for the position. The Director of OM's approval must be obtained if the proposed salary is more than 10 percent above the employee's highest previous pay or the proposed salary exceeds the maximum pay for the employee's current grade.
4. A promotion increase of no more than 15 percent above an employee's current base pay is allowed to achieve pay equity within a division or office or other unusual circumstances.
5. The salary cap maximum adjusted base pay that any Finance Board employee can earn, including locality pay is set at \$225,000, effective January 8, 2006. Any employee whose adjusted base pay is in excess of this amount at that date is not subject to this cap; however their salary is frozen as of January 8, 2006; and any future merit increases would be treated in the same manner as an employee who has reached the maximum salary of their grade level. The policy was modified again on October 22, 2007 to allow the Chairperson to make annual changes to the salary cap maximum, but without any amendments to it for those employees whose salaries were frozen and remain unchanged as of January 8, 2006.
6. The TF-5 grade level is eliminated beginning in 2006.

*Agency Employees Were Not Provided Adequate Information To Verify Merit Increase Calculations*

For the period we reviewed, we identified five instances where merit increases were calculated incorrectly and resulted in an underpayment or overpayment to some employees. If the affected employees had written policies and procedures on how their merit increases were calculated, they may have identified them and brought these errors to OM's attention before OIG. However, we found that while Finance Board written compensation policies and procedures were revised five times, there was no evidence that copies of the original policy dated September 17, 2001 or three subsequent revisions of it were distributed to all agency employees nor were they posted electronically on the agency's website along with a notice to employees that they were posted. We only found the latest Compensation Policy revision dated October 22, 2007 on the agency's website. In fact, we found that for the last two Compensation Program policy revisions dated October 22, 2007 and August 31, 2006, sections requiring OM to ensure that the Compensation Program policy is made available to all Finance Board employees were removed.

For the period we reviewed, agency staff had to visit OM to obtain a hard copy of the Compensation Program policy. This practice did not facilitate employees' awareness of compensation policies and consequently limited their ability to determine the propriety of pay actions that impacted them.

*The Lack of Adequate Written Internal Operating Procedures Within OM Greatly Contributed to Instances of Inaccuracies In Calculating Merit Pools and Merit Increases*

For the period we reviewed, OM had not developed and implemented written internal operating procedures for OM staff that outlined OM's process for accurately computing merit pay increases and that assigned responsibility for various segments of the process to OM staff members. Specifically, 1) responsibility for assuring the accuracy of office merit pool calculations was not clearly assigned, 2) responsibility for assuring the accuracy of merit increase calculations by Office Directors was not assigned, and 3) responsibility for ensuring that merit pay calculations were properly documented in employees' personnel files were not assigned. As of March 28, 2007, OM had developed procedures designed to document the merit pay increase process and to show who was responsible for each segment of the process. However, the new procedures continued to assign responsibilities to "HR" (OM's Human Resources Division) without indicating who within HR was specifically responsible.

In the absence of good internal procedures that clearly identify assigned duties within OM, we found irregularities in the calculations of offices' merit pools, errors and disregard of policy in calculating merit pay increases, and employee merit increase calculations that were not adequately documented.

**Lack of Adequate Internal Operating Procedures and Management Oversight Resulted In Incorrect "Merit Pool" Amounts**

We found two examples where offices' merit pools were not computed in accordance with agency policy. One of these cases occurred in 2005 and involved OM – the office responsible for ensuring the proper calculation of merit pay increases. Specifically, the amount of merit increase pool each office is allowed is shown on the Merit Increase Certification Sheet (MICS) prepared by OM and distributed to each Office Director (See Attachment 1). As Office Directors input the desired percentage increase for each employee onto the MICS, the dollar amount of the employee's merit increase is automatically calculated and the amount of funds remaining in the merit pool for distribution is also automatically calculated and shown on the MICS. For 2005, OM had \$2,159 remaining in their pool after inputting merit increase amounts for all but one of its employees. Although the remaining available pool amount of \$2,159 was clearly shown on the MICS, the Deputy Director wrote in a merit pay increase amount of \$5,867, which is \$3,708 in excess of the allowable amount. While OM provided the control to ensure other offices complied with the limits on merit pool amounts, there were no controls to ensure OM's compliance. Both the Director and Deputy Director of OM advised that they were unaware that they violated the agency's policy until we brought this instance to their attention. However, the records show that the Deputy Director disregarded the remaining pool amount of \$2,159 that was computed by the formula embedded in the MICS to write in the \$5,867 amount which was ultimately input into the payroll system by his staff. The Deputy Director advised that he could not explain why he awarded a merit increase amount that exceeded the remaining merit pool balance, but he did state that he signed the MICS form. The OM Director advised that she could not explain why the change was made.

In the second instance, we found that for 2006, OM under stated the merit pool for an office by 8 percent before it was caught by the office. OM officials advised that the error occurred because no one in OM had responsibility for verifying the merit pools calculated on the MICS by OM before the MICS were sent to Office Directors for completion. OM's Human Resources Officer advised that the error in calculating the office's 2006 merit pool was the result of many miscommunications on the delegation of responsibilities for computing the pool amount. She said that the assigned responsibility for verifying the calculation of offices' merit pool was not made clear until after OIG brought the mistake to OM's attention. However, the Deputy Director of OM advised that this was the result of human error. OM has implemented new internal operating procedures since we brought this matter to their attention. However, the procedures do not specifically identify the position or person accountable for performing specific duties. Consequently, the risk that errors in calculating the merit pay increases may occur and go undetected by OM officials remains high.

*Lack of Adequate Internal Operating Procedures Resulted In Employees' "Merit Pay Increase" Calculation Errors*

We found three instances where errors in calculating employees' merit pay increases were not caught and were included in employees' pay. One instance resulted in an employee improperly receiving both a lump-sum merit payment and a recurring biweekly payment. The other two resulted in one time underpayments of \$24 and \$178. Although the amounts of the three instances we identified are small, there were no controls to detect small or larger calculation errors.

The first instance involved an OM employee's 2007 merit increase. Specifically, the 2007 merit increase calculations resulted in a \$198 lump-sum merit payment. However, in calculating the employee's biweekly merit increase, OM neglected to first deduct the \$198 lump-sum merit payment resulting in a double payment over the 2007 pay period. OM's Human Resources Officer advised that this was an oversight error in calculating the employee's merit pay.

For the two other instances, we found that the 2005 merit increases were incorrectly calculated, were entered into the payroll system by OM, and were reflected in the two employees' pay. Specifically, we found a merit pay increase calculation error for one employee that resulted in a one time \$24 underpayment and one for another employee that resulted in a one time \$178 underpayment. OM could not explain how the \$24 error occurred; however the OM Deputy Director advised us that the underpayment had been corrected. For the \$178 error, the OM Deputy Director informed us that the HR office may have forgotten to adjust the form for the employee, but also advised that the underpayment had been corrected. However, these errors could have been avoided if responsibility for verifying the information on the MICSs had been properly assigned to OM staff.

*Lack of Adequate Internal Operating Procedures Resulted In Inadequate Documentation in Employees' Official Personnel Files (OPF)*

We found instances where salary authorizations were made for two employees that were not properly documented in their Official Personnel Files (OPF's). In the first instance, due to a change in the agency's leadership, an employee lost their job and accepted a step-down grade transfer. OM officials

informed us that Federal rules per the Office of Personnel Management transition guidance require such transfers to be made immediately. The situation occurred in the middle of a pay period and also at the change in the agency's annual salary structure adjustment process. Consequently, OM officials advised that they were faced with quickly making the transfer while lessening the impact on the employee.

The Human Resources Officer explained that the employee's adjusted salary (base salary multiplied by locality percentage) was used to determine the lump-sum merit amount of \$3,938 that was paid; however there was no documentation to support this in the OPF's. We found no mention in agency policy regarding the use of the adjusted base pay in the determination of the lump-sum merit amount. In accordance with agency policy and practices, when the merit increase causes the base pay to exceed the maximum base pay, the Finance Board is to pay the remaining balance to the employee in a lump-sum merit amount. The Deputy Director, OM informed us that there are no written agency procedures that describe how a case like this (lump-sum merit amount) should be handled, however what was done is consistent with Federal Personnel Regulations. However while the OPM regulations provided by OM support the employee's transition, it did not support the merit pay actions taken by OM, nor did OM provide any other federal regulation to support it. In addition, the employee's OPF's did not contain adequate documentation to explain why the employee's pay was not consistent with the agency's written policies and in the absence of such documentation, we had to rely on the memory of OM officials to explain this important transaction.

OM officials informed us that the second instance resulted from a reorganization that occurred within the agency in 1998 in which an employee was given a two-year grade and pay retention in accordance with the Office of Personnel Management (OPM) guidelines under "Subchapter S9 Grade and Pay Retention Under the Federal Wage System." Following the expiration of the two-year grade retention, the employee was allowed to retain her base salary (i.e., pay retention) in accordance with the same OPM guidelines. This continued for almost seven years during which the Finance Board allowed the employee to be eligible to receive annual merit increases, which had to be distributed via lump-sum merit payments because her retained base salary exceeded the base salary maximum for her grade. While we found the signed acceptance letter for the initial two-year grade retention agreement in the employee's OPF's, there was no documentation to support the new pay retention entitlement or the allowable eligibility for annual merit increases.

The OM Deputy Director informed us that there are no written agency procedures that describe how a case like this should be handled; however, what was done with regard to the employee's pay retention is consistent with Federal Personnel Regulations. Per the OM Deputy Director, form SF-50Bs do not provide space for HR offices to explain why or how employees' salary levels are set and adjusted and OM has not found it necessary to include this type information in the OPF's or other records. We found that OPM guidelines require the issuance of a letter to the employee describing the circumstances warranting a grade and/or pay retention and the nature of that entitlement; however OM officials could not provide any evidence of the letter. The absence of this required documentation places the agency at risk should a disagreement ever arise surrounding the circumstances of the actions taken by the agency.

## Recommendations

We recommend that the Director of OM:

- 1) circulate all current merit pay increase policies and procedures and policy changes (including “pen and ink” changes), to the Board members and agency Office Directors for review and comment before finalizing and updating agency policies;
- 2) make all HR policies available to all agency employees electronically on the agency’s website, which would allow agency employees to review policy practices at their own liberty. Further, all policy changes should be updated, announced to all employees, and posted electronically within 60-90 days of approval;
- 3) develop and implement internal operating procedures that clearly assign responsibility to a position or person for verifying merit increase calculations before they are input into the NFC payroll system and for verifying NFC output information on Finance Board merit pay increases;
- 4) propose revisions to the merit increase policies and procedures, before the next merit increase process, to clearly explain how merit pay increases are calculated and to require that Office Directors or their designees explain to each employee how their merit increase was calculated; and
- 5) develop and implement internal operating procedures that require all personnel changes (including corrections in employee compensation), be properly documented and supported in the OPF files.

## Auditee Response:

The OM Director was unwilling to provide comments on the accuracy of the report and on any corrective actions taken to address the report recommendations. He does commit to considering our recommendations in the creation of a new compensation policy for the Federal Housing Finance Administration (see Appendix 2). However, we believe these recommendations should also be considered in preparing the Finance Board’s Fiscal Year 2008 merit pay increases.

## **MERIT PAY RULES NEED TO BE REVISED TO ALLOW EMPLOYEES OF SMALLER OFFICES TO HAVE FULL ACCESS TO MERIT INCREASES**

The essence of a merit pay compensation system is that employees are compensated based on the level of contribution they make to their employer. An employee performing at an outstanding level in an office of few employees should have the potential for receiving merit increases comparable to employees in offices with many employees. Tying merit pay increases to the number of employees in an office without provisions for exceptions, results in arbitrary limits on pay increases employees can receive despite their meritorious service to the agency. Such a policy unfairly limits the pay of highly productive employees who work in smaller Finance Board offices and could have a result contrary to the intent of merit pay in that it could negatively impact smaller offices’ abilities to attract and retain highly qualified employees.

This rule does not apply throughout the agency as Finance Board guidance does not impose merit increase pool limitations on those employees who work for the agency's Board Members' offices. However, the guidance requires that merit increase pools for other Finance Board offices be limited to a percentage of the respective office's total employees' base pay. Specifically, the Finance Board procedures for calculating the pool are: 1) add the Presidential approved federal government-wide general increase to the Chairman approved 2.5%, and 2) multiply the resulting sum by the total of all office employees' annual base salary at the end of the fiscal year.

We found that, particularly for offices with smaller numbers of staff, the pool amount for each office may not provide adequate funds for the Office Director (or their designee) to award staff for their noted achievement/accomplishment. For example, in one office with few employees, two employees received outstanding ratings, but because the office pool was so small, the Office Director had only enough funds to provide the minimum merit pay increase of 4.75% for their outstanding performance. If there was no limit on the pool, agency policy would have allowed the employees to receive up to a 6.5 percent increase. One of the employees received government-wide recognition for his performance, a source that is available to all Office Directors. However, it should not be used as a substitute because of an inadequate amount of merit pool dollars available to Office Directors for rewarding employees for their outstanding performance.

The Finance Board merit pool rules are not a standard federal agency approach. OPM officials advised us that there are no federal regulations or guidance regarding merit pay pools. Thus a provision in the Finance Board's policies and procedures would provide managers greater flexibility and help facilitate a more fair and equitable compensation process. The Director of OM advised that the issue has never been raised before.

We did find however; that the agency's revised Compensation Program policy dated October 22, 2007 allows for policy exceptions to include provisions for increasing the merit pool. While we commend OM for establishing this provision, the approval authority for granting exceptions should reside with the Finance Board Chairman and not with the OM Director for several reasons: 1) the policy should not allow for a Director level approval of another Director's request for compensation provisions; 2) the OIG's office reports directly to the chairman to include requests for compensation provisions; and 3) the agency should require the chairman's approval for all OM internal compensation policy exceptions to maintain confidence and to help avoid the appearance of a conflict of interest in approving compensation matters. We found the need for such intervention in the example reported earlier where in 2005, OM exceeded its merit pool limit. Both the Director and Deputy Director advised that they did not realize they were violating the agency's policy when they exceeded their merit pool limit by \$3,708. However the establishment of a policy requiring the chairman's approval for such compensation matters could have detected the policy violation, released OM from the appearance of questionable internal approvals, and maintained confidence in our agency's compensation process.

**Recommendation**

We recommend that the Chairman approve a change to the compensation policies and procedures to allow Office Directors to request the Chairman's approval for increases to the currently computed merit increase pools, in order to provide managers greater flexibility and help facilitate a more fair and equitable compensation process.

**Auditee Response:**

The Counsel to the Chairman disagreed with our recommendation. He indicated that since no director has complained about the current policy, he prefers to keep the policy as it is now. Additionally, he noted that since the Finance Board is such a small agency, that any office director can easily appeal an OM decision directly to the Chairman. We do not agree with management's position because it does not address the deficiency noted during our audit. Specifically, in the absence of better controls, OM, the office responsible for processing merit increases, violated the agency's policy limiting merit increases and the violation went undetected until our audit. The current policy does not address this problem.

## APPENDICES



## Annual Merit Pay Process

The merit pay process includes the following steps (see continued pages 2-3 below for an example of the merit pay calculation process):

- 1) Supervisors completing annual performance evaluations for each employee at the end of each fiscal year,
- 2) The President deciding the Cost Of Living Allowance (COLA) percentage that each federal employee should receive,
- 3) OM's Human Resources Division's distributing "Merit Increase Certification worksheets" to all Office Directors for completion. (See continued page 3),
- 4) Office Directors, or their designees, subjectively deciding the merit increase each employee under their supervision should receive based on agency guidelines. For FY 2006 merit increases, the merit increase amount ranges available for managers to award based on various performance ratings were as follows: Outstanding rating - from 4.75% to 6.5%, Commendable rating - from 3.5% to 5.5%, Fully Successful rating - from 2.5% to 4.5%, Acceptable rating and below was zero percent.
- 5) Multiplying each employee's "base salary" at the end of the fiscal year by the percentage of merit increase subjectively selected by managers for each employee to determine the dollar amount of the merit pay increase. The total amount of merit increases awarded each office – the Merit Pool - is limited to a percentage of the office's employees' total base salaries at the end of the fiscal year. The percentage used to compute the amount of the merit pool is a composite of the General Increase percentage for federal employees that was declared by the President and a Finance Board Incremental Increase percentage approved by the Chairman. For FY 2006, the Merit Pool for each Finance Board office was determined by multiplying the office's total employees' base salary by the composite percentage of 4.6%,
- 6) The merit increase amount is added to an employee's end of fiscal year base salary to establish the employee's "new base salary,"
- 7) The employee's "new base salary" is then multiplied by the geographical pay differential or comparability rate for the geographical area where the employee is assigned. This results in the new "adjusted base pay" for the employee, and
- 8) If the employee's "new base salary" exceeds the maximum pay for an employee's grade level, the amount exceeding the maximum pay limit is paid to the employee in a lump- sum.

<b>Step Number</b>	<b>Process Step</b>	<b>Information Shown for 2007 Calculation</b>												
1	Office Directors Complete Annual Performance Evaluation for Employee at the end of each Fiscal Year	<b>Choices of:</b> Outstanding (O) Commendable (C) Fully Successful (FS) Minimally Acceptable (MA) Unacceptable (U)												
2	President Determines Cost of Living Allowance (COLA) also called General Increase	1.7%												
3	Finance Board Chairman Approves Incremental Increase Percentage	2.5%												
4	Merit Pool Rate (1.7% +2.5%)	4.2%												
5	Total 2006 Base Salaries for 2 employees (Hypothetical)	\$180,000												
6	Total Available Merit Pool (4.2% x \$180,000)	\$7,560												
7	2007 Merit Increase Ranges for Performance Ratings	<table border="0"> <tr> <td><b>RATING</b></td> <td><b>RANGE</b></td> </tr> <tr> <td>O</td> <td>4.75%--6.50%</td> </tr> <tr> <td>C</td> <td>3.50%--5.50%</td> </tr> <tr> <td>FS</td> <td>2.50%--4.50%</td> </tr> <tr> <td>MA</td> <td>0%---0%</td> </tr> <tr> <td>U</td> <td>0%---0%</td> </tr> </table>	<b>RATING</b>	<b>RANGE</b>	O	4.75%--6.50%	C	3.50%--5.50%	FS	2.50%--4.50%	MA	0%---0%	U	0%---0%
<b>RATING</b>	<b>RANGE</b>													
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U	0%---0%													

Example of Process for Calculating 2007 Merit Percentage and Available Merit Pool for 2007 for Two Individuals

A	B	C	D	E	F	G	H	I	J	K	L	M
Employee	Location	Geographic Rate	Grade	2006 Base Salary	2006 Merit Rating	2007 Merit %	2007 Merit Increase \$	2007 Total Calculated Base Pay	2007 Base Salary Range Maximum	2007 Base Salary (lesser of col I or J)	2007 Adjusted Salary (col C x K)	2007 Lump Sum Merit \$ (col I - col J)
Number 1	Washington DC	16.30%	14	\$ 100,000	C	4.20%	\$ 4,200	\$ 104,200	\$ 114,868	\$ 104,200	\$ 121,185	\$ -
Number 2	Washington DC	16.30%	12	\$ 80,000	C	4.20%	<u>\$ 3,360</u>	\$ 83,360	\$ 81,298	\$ 81,298	\$ 94,550	\$ 2,062

Example of Process for Calculating 2007 Adjusted Salary and Lump Sum Payments for Two Individuals

**Annual Merit Pay Process  
2006 TS & TM MERIT INCREASE  
CERTIFICATION SHEET**

<b>OFFICE:</b>
<b>DIRECTOR:</b>

<b>POOL AMOUNT</b>	<b>\$0</b>
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**Instructions:**

1. Verify each employee's performance rating.
2. Enter the 2006 merit increase percentage in Column F adhering to the following guidelines:
  - a. Outstanding = 4.75% to 6.5%.
  - b. Commendable = 3.5% - 5%
  - c. Fully Successful = 2.5% - 4.5%
  - d. Total Merit Increases cannot exceed performance award pool amount.
3. As a result of their merit increase, an employee's salary may exceed the top of their current salary range. If this is the case, the employee' salary will be set at the top of their salary range and the difference will appear as a lump sum merit increase in column K.
4. Print and sign the certificate and forward it to the Associate Director, Human Resources & Administration Division

A	B	C	D	E	F	G	H	I	J	K
#	Name	Grade	2005 Rating	2005 Base Salary	2006 Merit %	2006 Merit Increase \$	New 2006 Base Salary	New 2006 Adjusted Salary (Includes GEO%)	2006 Base Salary Maximum	2006 Lump-Sum Merit
1										
2										
3										
				\$0			\$0			

Example of 2006 TS & TM Merit Increase Certification Sheet



## Federal Housing Finance Board

1625 Eye Street, N.W., Washington, D.C. 20006-4001

Telephone: (202) 408-2500

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September 17, 2008

To: Edward Kelley  
Inspector General

From: David A. Lee  
Director  
Office of Management

Subject: Final Audit Report on Merit Pay Processing

Per our meeting with the Chairman today regarding the above referenced subject, as the Federal Housing Finance Board and the Office of Federal Housing Enterprise Oversight are merged into the Federal Housing Finance Agency (FHFA), and a new compensation policy is created, we will consider the recommendations contained in the subject report concerning strengthening internal controls over the methods by which salary increase determinations are made and implemented.

2008 SEP 18 PM 4 31