Lessons Learned from First Wave of CEO Pay Ratio Disclosures

Directors shouldn't become complacent on pay.

BY TODD SIRRAS

The first wave of CEO pay ratio disclosure has come and gone with much less attention than anticipated.

Was the pre-proxy hubbub and handwringing more than was needed to address employee and shareholder questions, comparison to competitors and local companies, and the potential ire of the proxy advisory services?

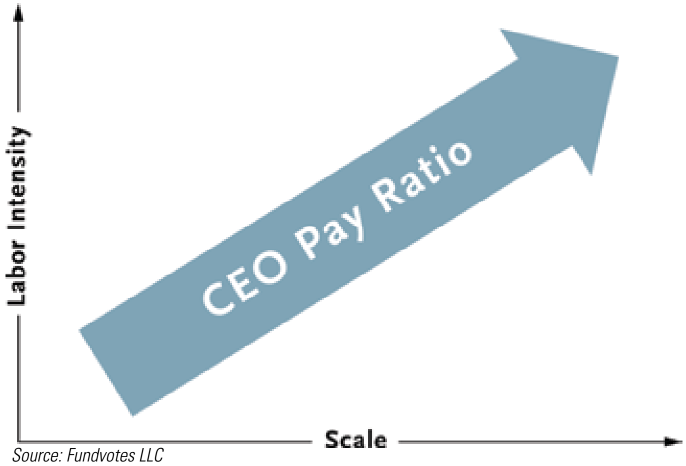
Here are three baseline learnings from the first wave of pay ratio disclosure and why boards and management need to pay attention to it going forward.

1. Pay ratio disclosure gives no new insight into pay practices.
This is the easy one, and the current headline. Median employee pay is the one new data point. It also is useless for understanding differences among companies. Comparing median pay at seemingly similar companies (Coke/Pepsi, Target/Walmart, Google/Facebook) tells you nothing about talent management and compensation systems. It's simply the middle of the employee list.

2. Scale and labor intensity drive pay ratios.
The relationship between CEO pay and revenue is well-documented and strongly positive. Higher CEO pay = higher CEO pay ratio.

Labor intensity, the ratio between labor and capital costs, is more complex and a combination of items: number of employees, number of locations, use of part-time/seasonal employees, global span of employee population, insourced operations/manufacturing, and customer touchpoints. Median employee pay goes down when you increase any of them. Lower median employee pay = higher CEO pay ratio.

(It's important to acknowledge under the topic of labor intensity that geo-



Source: Fundvotes LLC

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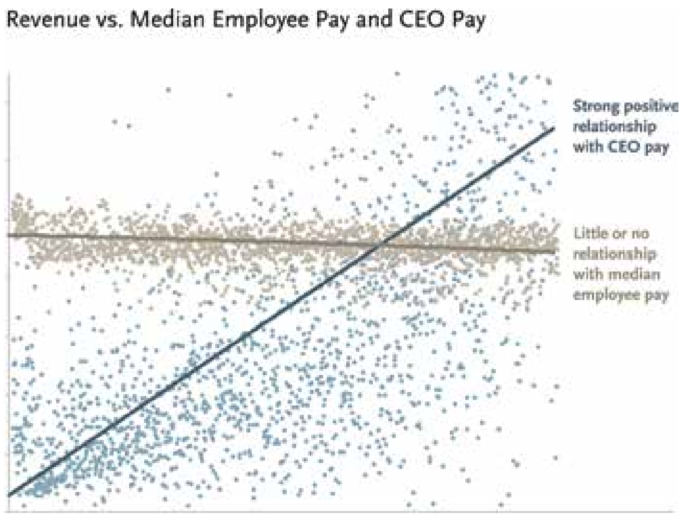

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graphic differences in competitive pay levels, especially in China/Southeast Asia, have a big impact on median pay.)

3. Median employee pay is not related to scale. This is why the CEO pay ratio doesn't tell us anything new about the relationship between CEO pay and overall pay. Labor Intensity is not a function of a company's size. The result when you combine these two is that similarly sized companies may wind up with very different CEO pay ratios, making comparability difficult.

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Simplicity makes the CEO pay ratio likely to become more prominent as time passes. Changes to a single number over time are easy to track, and the ratio will be influenced by multi-year trends as well as one-time events.

Gradual increases over time will occur if CEO pay continues to grow at a faster rate than overall pay levels, and could garner broad-based attention as an indication that CEO pay growth should slow.

One-time distortions in pay levels – hiring, multi-year, and one-time awards, to name a few – will create spikes and troughs in the ratio year to year. These are more common in CEO versus median employee pay since they are driven by individual circumstances.

All employee compensation is more stable year to year. For example, turnover of 15% of the population may occur every year with little impact on median employee pay. The primary drivers for short-term material changes in the median employee pay are mergers, acquisitions or major strategic initiatives that require headcount to grow or shrink.

Supplemental disclosure and rationale around the CEO pay ratio has been minimal so far but can be expected to increase over time as ratios change based on the factors above. Compensation committees and company staff should monitor changes to the ratio and its underlying components each year in order to make smart decisions about how to communicate to shareholders, employees and the media if the ratio attracts more attention. ■

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