08 | 2015
workspan
The Magazine of WorldatWork©

©iStockphoto.com/portarefortuna

A Five-Minute Guide to PAY RATIO DISCLOSURES

Understand pay ratio disclosures for executive compensation programs.

If an investor wants to know how much the CEO of a particular public company earns, he/she doesn't have to look any further than the company's annual proxy statement — it's a required disclosure. However, Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act

By Takis Makridis and Therese Sebastian, Equity Methods LLC

In our view, companies should seriously consider taking advantage of the opportunity to add **NARRATIVE** and supplementary **NUMERICAL COLOR** to their disclosures.

of 2010 aims to enhance this information by requiring companies to disclose the CEO pay ratio or the total annual compensation ratio of the median employee to the CEO. As with many other areas of the Dodd-Frank law, Congress left the details on implementation up to the U.S. Securities and Exchange Commission (SEC). The SEC released proposed rules in 2013, with final rules expected sometime this year.

Pay ratio disclosure has had mixed reviews. Some believe it will create more transparency for investors. Others think it will add another layer of administrative complexity to the financial reporting process.

Today, there are more questions than answers about the proposed pay ratio rules. But let's start with what we do know. First, the SEC slightly modified the Dodd-Frank provision to require companies to disclose the following:

- The median of the annual total compensation of all employees except the CEO
- The CEO's annual total compensation
- The ratio of the two.

Companies are allowed to choose how they identify the "median" employee: by using the full employee population or by using a statistical sample. Companies also have leeway in the definition of compensation (such as base salary) to identify the median employee. However, once this median employee has been identified, the total compensation of that employee needs to be calculated using the same methods that are required for executive compensation disclosures.

The proposal is pretty flexible in that companies are allowed to supplement the pay ratio with an explanation, plus any other relevant figures they choose to present. As with other areas in proxy disclosure, sometimes less is more, but sometimes more is more. Companies should consider taking advantage of the opportunity to add narrative and supplementary numerical color to their disclosures. After all, in the absence of information, people will draw their own conclusions.

Consider the case of a global technology company, TechCo A, where the median employee is a web developer in India. Because of differences in cost of living, the ratio of the CEO's salary to this median employee's salary is much higher than it would be if only U.S.-based web developers were considered. Explaining this nuance helps bring the company's pay ratio into perspective.

Now, TechCo A is exposed to criticism for excessive offshoring. But suppose there's a competitor, TechCo B. This company employs few U.S. citizens, but because its median employee is a developer in Ireland, its pay ratio is lower than TechCo A's. Here, TechCo A's strategy might be to disclose the number of people employed in the United States and India, revealing a relatively equal split. Further, TechCo A might disclose figures that show it pays above market in each of its international offices and maintains low turnover.

As a result, no matter what TechCo B chooses to disclose, TechCo A can tell an enlightening story through well-coordinated data gathering and analytics about its own workforce.

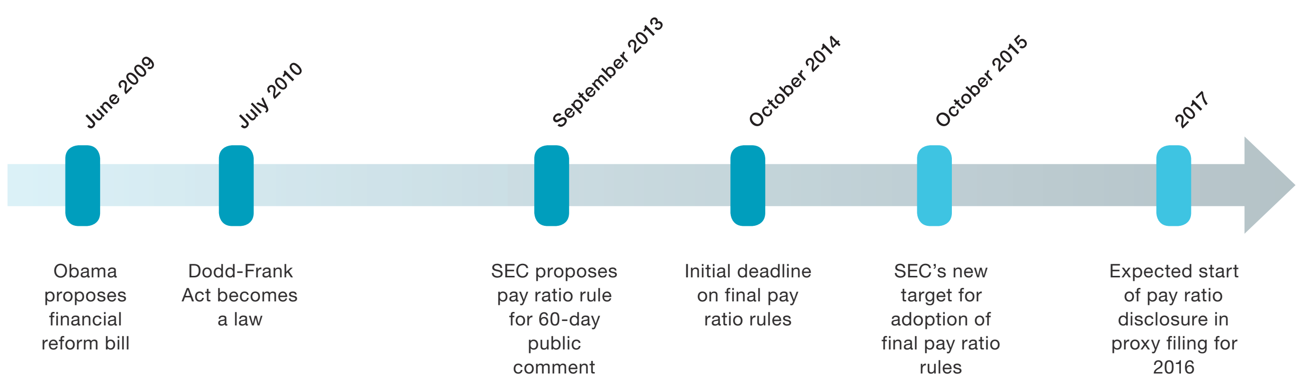
Perform an initial TEST CALCULATION now, before time becomes an issue. This will give you a good sense of any firm-specific challenges ...

It's prudent to assume that individual shareholders, institutional investors, the media, proxy advisers, politicians, advocacy groups, unions, employees and others will pay attention to CEO pay ratio disclosures. So the supplemental information employers choose to provide should reflect the sorts of sensitivities to which the company is exposed. If it isn't offshoring or lower-wage workers, it might be layoffs, changes in strategy, corporate social responsibility or any number of other issues. Corporate counsel should help you determine the appropriate level of detail to disclose.

It is worth considering what population to include in the pay ratio. The proposed ruling broadly defines "all employees" to include full-time, part-time, temporary, seasonal, non-U.S. and subsidiary employees. Although a statistical sample of employees is allowed, that sample must represent the entire employee population. For internal purposes, it may make sense to analyze the entire workforce, at least for the first year or two until the SEC or auditors decide how to test that a sample is representative.

The SEC is expected to release final pay-ratio rules by fall. If that happens, companies probably will have to calculate the pay ratio for the first fiscal year starting on or after the effective date of the final rule (Figure 1). For example, if the final rule becomes effective in October 2015, companies operating on a calendar year basis will provide the pay ratio disclosure for 2016 in a proxy filing in 2017. However, this may change once the final ruling comes out.

FIGURE 1 Proposed CEO Pay Ratio Timeline



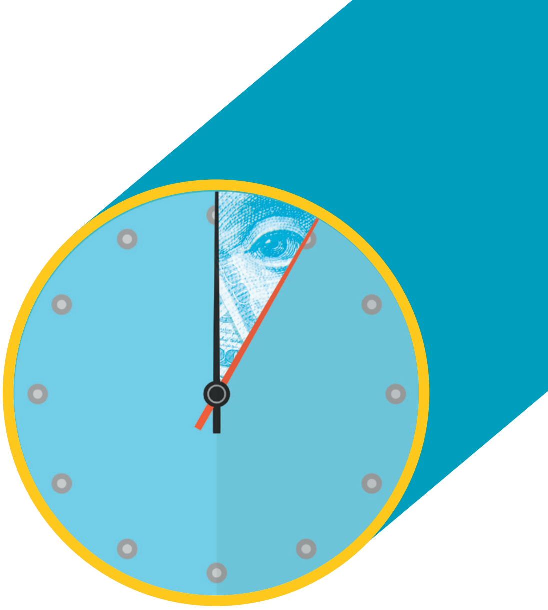
Section 953(b) of the Dodd-Frank Act: CEO pay ratio disclosure

128,000 comments received by the SEC

2015 when the SEC expects to issue a final pay ratio rule

Companies may need to start providing pay ratio disclosures as early as next year.

Perform an initial test calculation now, before time becomes an issue. This will give a good sense of any firm-specific challenges imposed by human resources, recordkeeping systems, geographic dispersion and varying definitions of pay across countries. If possible, perform the full calculation instead of a sampling exercise because it's still unclear how auditors will require companies to prove their samples are representative of the overall population. This may be an reiterative process in the beginning, but can go a long way in ensuring a robust methodology for a value that may face high levels of scrutiny.



Takis Makridis is CEO and president of Equity Methods LLC in Scottsdale, Ariz. He can be reached at 480-428-1203 or takis.makridis@equitymethods.com.

Therese Sebastian is a valuation associate at Equity Methods LLC in Scottsdale, Ariz. She can be reached at 480-428-3327 or therese.sebastian@equitymethods.com.

resources plus

For more information, books and education related to this topic, log on to **www.worldatwork.org** and use any or all of these keywords:

- Pay Ratio
- Executive Compensation
- Securities Exchange Commission.