The US Securities and Exchange Commission’s (SEC’s) proposed pay ratio rule is likely to be costly to companies and have little value to investors. This controversial provision of the Dodd-Frank Act requires companies to disclose the relationship between the CEO’s annual total compensation and the median annual total compensation of all other employees — information most companies have never tracked and few investors have been seeking.

Recognizing that the rule is mandated by statute and will very likely take effect, it is important for companies to present information that is accurate, reliable, consistent, and comparable from year to year. In comments to the SEC, Mercer recommended changes to the proposed rule to:

- Promote the integrity and consistency of each company’s calculation from year to year and reduce compliance costs.
- Allow more time for annual disclosures.
- Limit the potential for litigation.

This Perspective summarizes the rule’s key provisions, explains Mercer’s recommendations to the SEC, and lists some potential implications of the disclosure requirement as proposed.
KEY PROVISIONS

The act requires companies to disclose the annual total pay of the median employee and the CEO, and the ratio between the two in annual proxy statements and other filings that include executive pay disclosures. Companies must use the proxy statement’s Summary Compensation Table (SCT) methodology to determine annual total pay. The SCT definition goes beyond salary and cash bonuses, and includes stock and option awards, change in actuarial present value of pension benefits, above-market earnings on deferred compensation, and certain perquisites and benefits.

To ease the compliance burden, the proposal would not require companies to use the SCT methodology to determine the median employee but would give companies flexibility to use a method that best suits their particular circumstances by allowing them to:

- Use their full employee population or a statistical sample.
- Choose a “consistently applied compensation measure,” such as wages and overtime amounts reported in payroll or tax records in lieu of SCT pay.
- Use a “reasonable estimate” to calculate the compensation of employees other than the CEO.

But, the proposed rule offers no relief regarding the scope of employees covered — full-time, part-time, temporary, seasonal, and non-US employees would all need to be taken into account in determining the median employee. And once the median employee is selected, his or her total compensation must be calculated using the SCT methodology.

Companies would have to comply with the rule starting with compensation paid in the first fiscal year beginning on or after the effective date of the final rule. If the SEC finalizes the rule by October 2014, as indicated in its recent tentative rule-making agenda, disclosure would be required for 2015 compensation in 2016 proxy statements for calendar-year companies. Emerging growth companies, smaller reporting companies, and foreign private issuers would be excluded.
REDUCING COSTS AND ENHANCING CONSISTENCY

Compiling the required data and calculating the pay ratio will be extremely expensive and time consuming for many companies. For example, one of Mercer’s clients has 32 separate payroll systems in the US alone. Another Mercer client has operations in 60 locations on four continents, operating in four business units with 42 separate payroll systems in multiple currencies.

The SEC’s flexible approach may help companies reduce their compliance costs, but there could be large year-to-year swings in the median employee’s pay level that result in misleading ratios. This volatility could occur due to factors such as geography, age, and years of service, even if a company uses a consistent method for determining the median employee and does not significantly change pay levels. Efforts to analyze the underlying data, determine the reason for any change, and prepare a clear explanation for variations would require additional time and costs not considered in the SEC’s proposal.

To bolster the year-over-year integrity of each company’s ratio while still managing the costs of compliance, the SEC should allow companies more flexibility than is provided in the proposal. For example, allowing them to (1) exclude certain types of employees, (2) use a range or average of median employee pay or multiple statistical samples, and (3) exclude certain types of compensation from total annual pay — provided they explain their rationale and act consistently from year to year — would reduce costs and enhance consistency.

1. EXCLUDE CERTAIN TYPES OF EMPLOYEES

Consistency could be increased and costs reduced by excluding non-US, part-time, temporary, and seasonal employees, as well as employees of unconsolidated subsidiaries.

Exclude non-US employees. Most of the potential for large and misleading year-to-year swings in the pay ratio, and costs to develop and use a methodology that minimizes those swings, stem from the inclusion of non-US employees. Year-to-year swings could be the result of currency fluctuations, cross-border differences in pay and benefit programs, and expatriate pay programs. The potential impact of these factors is illustrated in the following examples, all of which assume CEO annual total compensation of $5 million.

“THE SEC’S FLEXIBLE APPROACH MAY HELP COMPANIES REDUCE THEIR COMPLIANCE COSTS, BUT THERE COULD BE LARGE YEAR-TO-YEAR SWINGS IN THE MEDIAN EMPLOYEE’S PAY LEVEL THAT RESULT IN MISLEADING RATIOS.”
Example 1 — currency fluctuation. At a multinational company, the same Japanese employee is at the median two years in a row. Even without any changes to this median employee’s pay level, the volatility of the Japanese yen relative to the dollar could significantly impact year-over-year pay comparisons. For example, if the median employee is paid ¥3.5 million both years, the exchange rate at 12/31/11 (76.98) would convert that amount to $45,466, for a pay ratio of 110:1. In contrast, the exchange rate at 12/31/12 (86.64) would convert it to $40,397, with the pay ratio jumping to 124:1.

Example 2 — expatriate compensation. A multinational company uses salary to identify the median employee. Two employees receive the median salary of $40,000. One is a US expatriate working in Singapore and the other is an employee in the US. When all expatriate benefits are included — cost of living, housing, and education allowances — the expatriate’s annual total compensation is $165,000, with a pay ratio of 30:1. In contrast, the US-based employee receives just salary and bonus of $44,000, and the pay ratio increases to 114:1.

Example 3 — differences in pay and benefit programs. A multinational company uses salary and bonus to identify the median employee. For the past two years, the median employee received $50,000 in salary and bonus. In year one, the employee is located in the UK, where he or she participates in a defined benefit pension plan that offers benefits above the statutory minimum — a common feature in that country. In year two, the median employee is located in India, which does not offer a retirement plan beyond the statutory minimum — typical practice in that country. Thus, while the two employees have the same salary and bonus, their total compensation is influenced by local benefit practices.¹

Exclude part-time, temporary, and seasonal employees. The inclusion of part-time and temporary employees distorts the relationship between the CEO’s compensation and the median employee’s if the median employee’s pay is not annualized. While companies could provide additional disclosure to clarify this, investors may focus exclusively on the ratio itself, and the additional explanations in the proxy statement may be overlooked.

Exclude employees of unconsolidated subsidiaries. It would make sense to exclude employees of unconsolidated subsidiaries since unconsolidated subsidiaries are excluded for most financial reporting purposes.

¹ Mercer’s global compensation and benefits surveys include a suite of annual Benefits, Policy, and Practice Reports for the UK, India, and 78 other countries.
2. USE A RANGE OR AVERAGE OF MEDIAN EMPLOYEE PAY

Although the proposal allows significant flexibility in using statistical sampling, consistently applied compensation methods, and reasonable estimates to determine the median employee, allowing companies to use a range of median employees or multiple statistical samples could dramatically reduce year-to-year swings in the pay ratio.

Provide a range or average of median employee pay. One way to reduce year-to-year fluctuations from selecting a single median employee would be to allow companies to use a range or average of several “middle” employees’ compensation. For example, a company that selects the median employee by arraying its entire population using salary could locate a limited number of middle employees within a symmetrical range around the median (such as the middle 1% of employees). Instead of computing annual total compensation for a single median employee, the company could compute annual total compensation for all employees within the range and either (1) present a range of annual total compensation for the middle employees and the associated ratios to the CEO’s pay or (2) calculate the average annual total compensation for all employees within the range and present that as the median.

Example 4. A company with 10,000 employees identifies the 5,001st employee as the median based on salary data. To help minimize the risk of year-to-year swings, the company might identify the 4,991st through 5,011th “middle” employees and compute annual total compensation for all 21 employees. The company could then either (1) present the range of annual total compensation and associated ratios for the highest and lowest paid of the 21 employees or (2) calculate the average annual total compensation for the 21 employees and present it as the median, along with the associated ratio.

This approach could also apply if the company identifies multiple employees with the same median salary.

Use multiple statistical samples. Another way to use ranges or averages would be to permit companies that identify the median employee using statistical sampling to select a number of samples, identify the median employee in each sample, and then compute annual total compensation for the median employee of each sample. The companies could then either present the range of resulting annual total compensation values and associated ratios, the average, or the median.

“...ALLOWING COMPANIES TO USE A RANGE OF MEDIAN EMPLOYEES OR MULTIPLE STATISTICAL SAMPLES COULD DRAMATICALLY REDUCE YEAR-TO-YEAR SWINGS IN THE PAY RATIO.”
3. EXCLUDE CERTAIN TYPES OF COMPENSATION FROM TOTAL ANNUAL PAY

Even for companies with only domestic operations, year-to-year pay ratio volatility could result from including defined benefit pensions in the total annual compensation figure. While the prevalence of defined benefit pension plans has been declining, 25% of Fortune 500 companies still have fully active plans, 17% have active plans closed to new participants, and 23% have frozen plans — all of which have to be taken into account in calculating total annual compensation.2

Allowing companies to exclude the change in pension benefits or use the average change in defined benefit pension values would greatly enhance year-to-year consistency and comparability.2

Exclude change in defined benefit pension values. Changes in defined benefit pension values are driven by age, service, and external factors such as interest rates, rather than decisions about pay levels. Pension plans are also likely to differ by country and among participants within countries. Allowing companies to exclude the change in defined benefit pension values under US qualified plans or broad-based foreign plans from total annual compensation for purposes of calculating the ratio would greatly reduce pay-ratio volatility and the accompanying need to investigate and explain the year-to-year changes.

Example 5 — pension benefits. A company uses payroll records to identify the median employee, who earns $50,000 in salary and participates in both the company’s 401(k) plan, receiving a $1,500 match, and the defined benefit pension plan. Assuming a typical defined benefit plan, total compensation could range from $51,500, with a pay ratio of 97:1, to $84,000, with the pay ratio dropping to 60:1, depending on the employee’s age and service and interest rates. Even for a specific employee — say, a 45-year-old with 10 years of service — the ratio could vary from 83:1 to 97:1 due to changes in interest rates of +/− 0.75%.

2 Mercer’s 2013 Executive Benefits Research Tool (EBeRT) database.
Use average change in defined benefit pension values. Allowing companies to use an estimated overall average change in pension value calculated with readily available data would decrease the cost of compliance and pay ratio volatility. Under US accounting rules, the accumulated benefit obligation (ABO) for defined benefit pension plans must be calculated and disclosed annually. The ABO represents the present value at fiscal year end of all benefits earned for service through fiscal year end by all plan participants but does so by using accounting assumptions (including best-estimate turnover and retirement assumptions) instead of the simplified assumptions used in proxy disclosures. Companies should be allowed to reasonably estimate the change in the defined benefit pension value for a median employee who participates in a defined benefit plan by dividing the ABO by the number of plan participants.

TIMING OF DISCLOSURE

There may not be sufficient time between the end of the calendar year and the proxy statement filing date to complete all the work necessary to determine the median employee and calculate the ratio. Companies are already tasked with compliance requirements during the months immediately before and after fiscal year end. Making the pay ratio determination a year-end activity would only add to this burden — not just for large, complex companies but also for smaller companies with decentralized human resource information systems (HRIS) and limited resources.

It would be particularly difficult and costly for multinational corporations with tens of thousands of employees in dozens of countries with multiple HRIS and payroll systems. Decentralized HRIS and payroll systems managed by a diverse group of employees are not uncommon, especially for companies with recent merger and acquisition activity, whether domestic or global. The proposed rule would require them to compile and analyze data that are not otherwise normally available, are not required for any other year-end reporting purpose, and often can be obtained only by running manual reports.

This burden could be alleviated by allowing companies to delay the pay ratio disclosure until it is calculable and then file the disclosure in a Form 8-K (as is currently permitted where SCT salary or bonus cannot be calculated as of the most recent practicable date) or Form 10-Q.
POTENTIAL LITIGATION

The pay ratio disclosure should be treated as furnished rather than filed. Disclosure that is filed is subject to certain liability provisions under the Securities Act and the Exchange Act, and requires officer certifications under the Sarbanes-Oxley Act. While Mercer supports the flexibility the SEC has provided in the proposed rule, it may result in costly and time-consuming shareholder legal challenges to companies’ methodologies and assumptions for selecting the median employee. The likelihood of groundless litigation could be reduced by:

- Including examples of how statistical sampling and reasonable estimates might be used.
- Providing safe harbors for determining an acceptable sample size for companies that use statistical sampling (for example, based on standard statistical methodologies, a safe harbor of the lesser of 10% of the population or 400 employees might be appropriate).

IMPLICATIONS OF THE NEW DISCLOSURE

Once the rule becomes final, companies will have at least a year before they must disclose the pay ratio. And, assuming the final rule is similar to the proposal, they will likely need that time to collect data, analyze the employee population, choose an appropriate methodology, analyze the resulting ratio, and draft disclosure language. While the provisions of the final rule are yet to be determined, some possible implications include the following:

- Companies with centralized HRIS systems will have an advantage. It is unlikely that companies will choose to implement centralized compensation systems simply to comply with the rule because of the potentially significant time and costs required and relatively limited benefit. But those that have been considering centralizing HRIS systems may see compliance as a tangential reason to do so.

- Seasonal companies may be more challenged. Companies that hire large numbers of temporary and part-time employees during the holiday season — especially companies with calendar fiscal years — will likely produce pay ratios that are significantly higher than those in most other industries. These companies — typically, retailers — will need additional analysis to determine how best to comply, assuming the final rule does not provide them with some relief.
• **Companies will aim for consistent methods.** Standard methods for identifying median employees may develop over time, particularly for individual industries. In the early years of compliance, companies may need to change methods to find one that is not overly burdensome, accurately represents the company’s internal pay equity, and is comparable to peer company ratios. However, companies should be careful in choosing their initial method since material changes to the methodology or material assumptions, adjustments, or estimates and the reason for the changes must be disclosed along with an estimate of the impact of the change on the median and the ratio.

• **Litigation is a possibility.** Because recent litigation has taken aim at the adequacy and accuracy of proxy disclosure on executive pay and could extend to pay ratio disclosure, companies should be prepared to defend their methodologies, assumptions, and estimates to avoid costly and distracting lawsuits that can damage a company’s reputation.

• **Alternative ratios may become popular.** Some companies may choose to disclose alternative ratios to supplement the required ratio, similar to the way some companies prepare alternative SCTs. Possibilities include providing pay ratios for only US employees or only full-time employees, comparing the pay of other executives to CEO pay, or adjusting for mergers and acquisitions and other significant changes in employee composition.

• **Peer company comparisons — although flawed — may become common.** Despite protests about the irrelevance of the pay ratio, proxy advisors and the media may well seize on it as a snapshot comparison of CEO pay across companies. If a company’s pay ratio is significantly higher than its competitors’, the company will want to explain why. For example, a company’s ratio may differ from those of its competitors because of workforce makeup, outsourcing, or geographic range.

• **Increasing pay differentials and year-to-year variances may be red flags.** Beginning with the second year of compliance, proxy advisors, investors, and the media are likely to track year-over-year trends and view increasing differentials as indicative of problematic pay practices.

“...COMPANIES SHOULD BE PREPARED TO DEFEND THEIR METHODOLOGIES, ASSUMPTIONS, AND ESTIMATES TO AVOID COSTLY AND DISTRACTING LAWSUITS THAT CAN DAMAGE A COMPANY’S REPUTATION.”
TOO MUCH INFORMATION

Mercer supports the SEC’s mission to require public companies to disclose material information to aid investors in making investment and voting decisions, but the pay ratio disclosure will be of limited use to investors and compliance will require significant resources. The SEC notes in the proposing release that “… the lack of a specific market failure identified as motivating the enactment of this provision poses significant challenges in quantifying potential economic benefits, if any, from the pay ratio disclosure.” Similarly, at a recent industry conference, representatives of institutional investors and proxy advisory firms questioned whether and how they would use the disclosure. The ratio would not likely be considered material to a voting or investment decision and epitomizes the “information overload” noted by SEC Chair Mary Jo White in a recent speech — particularly if companies feel compelled to include detailed and lengthy disclosure to put it in context.

Additional resources

To learn more, we encourage you to visit our library of Perspective articles and visit www.mercer.com/talent.

PERSPECTIVE AUTHORS

SUSAN EICHEN
susan.eichen@mercer.com
+1 914 637 0373

AMY KNIERIEM
amy.knieriem@mercer.com
+1 202 263 3926

CAROL SILVERMAN
carol.silverman@mercer.com
+1 212 345 7056

GLOBAL CONTACTS

JAMES ROTH
(Global Leader, Rewards)
james.roth@mercer.com

MARK HOBLE (Europe)
mark.hoble@mercer.com

MARTIN IBAÑEZ-FROCHAM
(Latin America)
martin.ibanez-frocham@mercer.com

HANS KOTHUIS (Asia Pacific)
hans.kothuis@mercer.com

TIM NICE (Australia)
tim.nice@mercer.com

GREGG PASSIN (New York)
gregg.passin@mercer.com

SETH ROSEN, Editor (Los Angeles)
seth.rosen@mercer.com

MICHAEL THOMPSON (Canada)
michael.a.thompson@mercer.com

Executive Rewards & Performance Effectiveness Perspective is published by:

Mercer
1166 Avenue of the Americas
New York, NY 10036

This article is for information only and does not constitute legal advice; consult with legal and tax advisors before applying to your situation. You are welcome to reprint short quotations or extracts from this material with credit given to Mercer LLC.