



On the board's agenda | US

Preparing for the new CEO pay ratio disclosure requirement

In 2015, the Securities and Exchange Commission (SEC) issued a final rule¹ requiring disclosure of the ratio of Chief Executive Officer (CEO) pay to that of the median employee under Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The disclosure is required for the first fiscal year beginning on or after January 1, 2017, and as such, calendar-year companies will have to provide the ratio beginning with their 2018 annual proxy statement, based on 2017 compensation data. Despite this timeline, it is advisable that management consider providing the Compensation Committee with a preliminary assessment early in 2017, allowing

the Committee sufficient time to understand the ratio and the underlying calculation, and giving management time to develop its communication strategy (both internal and external).

Under the final rule, a publicly-traded company must annually disclose (i) the median of the annual total compensation paid to its employees (excluding the CEO), (ii) the annual total compensation paid to its CEO, and (iii) the ratio of the median employee's annual total compensation to the annual total compensation of the CEO.



¹ SEC Final Rule Release No. 33-9877, Pay Ratio Disclosure

What are the likely implications of the pay ratio disclosure rules?



The new rule has potential implications for directors, employees, shareholders, proxy advisory firms and other stakeholders as summarized below:

- The Board of Directors may be criticized for the gap between the CEO's and the median employee's pay, especially if it exceeds peer companies.
- The CEO pay ratio may have an impact on proxy advisory firms' voting recommendation for, and institutional shareholders' evaluation of, a company's advisory vote on executive compensation ("Say on Pay").
- Public disclosure of median employee annual total compensation may create employee relations issues as one-half of employees could learn they are paid in the "bottom half" of the company.
- Employees will also be able to determine median employee compensation at peer companies and other employers in their geographical market, which could cause dissatisfaction with their pay if median compensation at these other organizations is higher.
- Comparisons of pay ratios and median compensation at prominent companies, both within and across industries, are likely to be a focus by the media even though such comparisons may be misleading due to differences in workforce composition, geographic locations, etc.
- Any year-over-year increase in the CEO pay ratio is likely to attract heightened scrutiny, and companies should consider preparing a clear and easy-to-understand explanation of the increase.

Key components of the pay ratio rules.

1. Are any companies exempt under the rule?

The disclosure requirement does not apply to emerging growth companies, smaller reporting companies, foreign private issuers, U.S.-Canadian multi-jurisdictional disclosure system filers or registered investment companies. Newly public companies are not subject to the rule until the year following the one in which they became a public company (assuming none of the above exemptions apply). The same transition period applies to companies that no longer qualify as emerging growth or smaller reporting companies.

2. How is "employee" defined under the rule?

The definition includes all *"full-time, part-time, seasonal, and temporary employees employed by the company or any of its consolidated subsidiaries"*. A company may use any date within the last three months of the fiscal year as the median employee determination date. For example, a retail company with a January 31st year-end might consider using the employee population as of November 1st (i.e., before the full seasonal workforce is hired for the holiday season) to determine the median employee. The date used to identify the median employee must be disclosed.

While "employee" includes U.S. and non-U.S. employees, the rule provides two exemptions—the Foreign Data Privacy Exemption and the De Minimis Exemption—designed to alleviate some of the challenges associated with collecting global compensation data. It is unlikely that companies will be able to avail themselves of the Data Privacy Exemption, but in many cases, companies will be able to exclude up to 5% of non-U.S. employees from this calculation.

3. How to identify the median employee?

Companies can identify the median employee based on an analysis of the entire workforce, statistical sampling, and/or other reasonable methods. The identification of the median employee can be based on annual total compensation or any compensation measure applied consistently to all employees included in the calculation, as long as the chosen measure is disclosed. Base salary and wages may best reflect the compensation of the "middle of the workforce", but other measures of compensation, such as tax or payroll information (e.g., taxable income reported on Form W-2 or non-U.S. equivalent form), may also be used.

Large and complex global companies with decentralized payrolls will likely want to familiarize themselves with statistical sampling to determine the median employee. Sampling has the advantage of significantly reducing the amount of data that needs to be collected.

Companies are only required to identify the median employee once every three years. However, companies have to reasonably believe there have been no changes in the employee population or compensation arrangements that would cause a significant change to the pay ratio disclosure.

This triennial identification of the median employee is a welcome component of the new rule, as companies will not need to re-calculate the median employee every year, and the ratio should not fluctuate dramatically from year to year. While a well-designed compensation system would presumably see the ratio expand when the company is performing well, and decrease when it is not performing (since the CEO's pay is much more highly leveraged than the median employee), changes, as previously noted, should be carefully monitored and explained.



4. How to calculate total compensation?

The methodology summarized in the previous section may only be used to *identify* the median employee. Once that employee is identified, his/her “annual total compensation” must be calculated in accordance with the methodology specified by the SEC to determine “Total Compensation” for Named Executive Officers as reported in the Summary Compensation Table (SCT) of the annual proxy statement. The information disclosed in the SCT includes all types of compensation, such as salary, bonus or other non-equity incentive compensation, equity awards, changes in pension value, and all other compensation.

In general, the CEO’s compensation disclosed in the SCT is used to calculate the pay ratio. However, if additional items, such as company paid healthcare, are used to calculate total compensation for the median employee, such amounts must be included in the CEO’s annual total compensation. The inclusion of benefits in the calculation of total compensation, while not required, may materially decrease the pay ratio, as illustrated below:

	CEO	Median Employee	Ratio
Total Annual Compensation	\$4,200,000	\$42,000	100 : 1
Employer-paid Healthcare	\$12,000	\$12,000	N/A
Total Annual Compensation + Healthcare	\$4,212,000	\$54,000	78 : 1

Companies with more than one CEO during a fiscal year can select from the following approaches:

- Combine the annual total compensation for the individuals that served as CEO during the year, or
- Use the pay for the person serving as CEO on the date the company selects to determine the median employee, and annualize his / her pay for the year.

Regardless of which of the above approaches is utilized, companies must disclose the methodology used to calculate the CEO’s annual total compensation for the year. It is important to note that one-time sign-on or hiring awards may skew the pay ratio. Companies should consider including expanded disclosure to explain the impact of such awards on the CEO pay ratio.



Reporting the results of the CEO pay ratio to shareholders



While there is no prescribed method to identify the median employee, companies must apply the method they choose consistently to all employees included in the calculation, and explain the approach in a “brief” narrative. The disclosure should provide enough information to enable third-parties to understand:

- The measure of annual compensation used to identify the median employee.
- How annual total compensation is calculated, including any estimates used to determine non-cash compensation components.
- The actual ratio of the annual total compensation paid to the CEO to that of the median employee, which may be described narratively or numerically (i.e., the CEO’s annual total compensation is 50 times the median employee; 50:1 or 50 to 1).
- Any significant changes in an issuer’s methods, assumptions, adjustments or estimates from one year to the next.

Additionally, companies may prepare and disclose additional ratios or supporting information if this data will provide additional context in explaining the company’s CEO pay ratio. For example, companies with significant numbers of non-U.S. employees may wish to disclose an additional ratio based solely on U.S.-based employees, or salaried employees in order to provide investors with a better understanding of how employee pay demographics impact the ratio. To the extent companies want to provide additional information, the final SEC rule provides that any such additional disclosure should be “clearly identified, not misleading, and not presented with greater prominence than the required ratio”.

What should directors consider doing now to prepare and questions to ask

Given the potential adverse implications from the pay ratio disclosure, it is important for companies to start planning now, including developing their methodology for gathering the required compensation data, preparing the pay ratio disclosure, and creating an employee communication strategy in order to help mitigate potential employee relations risks. Even though statistical sampling may significantly reduce the effort required to prepare this disclosure, the process is likely to take longer than anticipated, and it is prudent to complete a “dry-run” based on 2016 compensation information to identify data gathering challenges and solidify a methodology that can be used going forward. Below is a summary of the proactive steps that directors can consider to prepare for the upcoming disclosure requirement:

- Ask management to provide a report to the compensation committee regarding its progress to date and/or project plan for the initial calculation of the CEO pay ratio and timing of subsequent calculations.
- Consider asking management to provide the compensation committee with a draft of the CEO pay ratio disclosure as early as possible (e.g., first half of 2017), so the committee has an understanding of the likely magnitude of the pay ratio to be disclosed in the 2018 proxy statement. This should allow management and the compensation committee time to consider the key messaging to investors given the results of the company's pay ratio calculation, and the potential benefit of voluntary disclosure of supplemental pay ratio calculations to enhance investors' understanding of how various aspects of company's employee demographics impacts the pay ratio results. These efforts should be addressed well before the required disclosure is finalized, in particular developing a narrative that highlights (i) the positive attributes of a company's compensation philosophy for employees and executives, and (ii) how the company's approach to compensation supports its strategic initiatives.

- Given the likely interest of the media and employees in the pay ratio disclosure, ask management to begin developing a robust communication strategy so the company is prepared, both internally and externally, to address potential questions about the new pay ratio disclosure.

Authors:

Michael Kesner
Principal
Compensation Strategies
practice
Deloitte Consulting LLP
mkesner@deloitte.com

Ian Dawson
Manager
Compensation Strategies
practice
Deloitte Consulting LLP
iadawson@deloitte.com

Tara Tays
Senior Manager
Compensation Strategies
practice
Deloitte Consulting LLP
ttays@deloitte.com

Contact us:

Deborah DeHaas
**Vice Chairman, Chief
Inclusion Officer, and
National Managing Partner**
Center for Board Effectiveness
Deloitte LLP
ddehaas@deloitte.com

Maureen Bujno
Managing Director
Center for Board Effectiveness
Deloitte LLP
mbunjo@deloitte.com

Bob Lamm
Independent Senior Advisor
Center for Board Effectiveness
Deloitte LLP
rlamm@deloitte.com

Debbie McCormack
Managing Director
Center for Board Effectiveness
Deloitte LLP
dmccormack@deloitte.com

Acknowledgements

Deloitte would like to extend special thanks to Jenny Kwech for her contribution to this publication.

About this publication

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte Network”) is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

About the Deloitte LLP Center for Board Effectiveness

The Center for Board Effectiveness helps directors deliver value to the organizations they serve through a portfolio of high quality, innovative experiences throughout their tenure as board members. Whether an individual is aspiring to board participation or a veteran of many board experiences, the Center's programs enable them to contribute effectively and provide focus in the areas of governance and audit, strategy, risk, innovation, compensation and succession.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.