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Understanding Executive Pay Equity and Fairness: Ratios and Rationality

Jim Bowers
Hay Group

Fred Whittlesey, CCP, CEP
Hay Group

Any examination of fairness in executive pay likely will meet with criticism. Many Main Street residents feel that executive pay is excessive; the media like to keep reminding them of this. Executive pay bashing has almost become a sport.

A recurring theme is the concept of "fairness." As the authors discussed the need for an article about the "fairness" of executive compensation, they went to the dictionary for help.

The historical roots of the word "fair" in old English and German mean "beautiful." When we discuss the notion of whether executive pay is fair, however, we're often referring to whether it is "marked by impartiality and honesty; free from self-interest, prejudice, or favoritism; conforming to the established rules; allowed; consonant with merit or importance; due" (Merriam-Webster 2010).

In economics, fairness is defined as the relation among economic factors where price matches fair value that is bias-free and rational. Executive pay today is under attack with concerns about improper bias by compensation committee members and consultants, and irrationality.

Many parties are weighing in on the issue of fairness and executive compensation, for example:

- Edgar Woolard, former CEO of DuPont, has long promoted the notion that fairness is defined as the CEO not being paid more than two times those at the next highest executive level.
- Kenneth Feinberg, the Obama Administration's Special Master of Executive Compensation, has been making decisions in light of overall fairness, considering performance, government bailouts and public perception.
- The Compensation Discussion and Analysis (CD&A) portion of the annual proxy statement for public companies requires justification of pay decisions, and "fairness" is one of the criteria.
- Shareholder interest groups also have jumped on the bandwagon in promoting fair and reasonable pay, ranging from say-on-pay proposals to specific pay limitations and disclosure of executive-to-employee pay ratios.
- Labor unions, especially the AFL/CIO, have been emphasizing the relationship of union labor pay to CEO pay and have promoted the concept of using reasonable multiples to determine top executive pay.
- Congress and the Securities and Exchange Commission (SEC) have been considering whether to require disclosure of pay multiples between executive and workers as a way to view pay reasonableness.

A BRIEF HISTORY OF FAIRNESS IN EXECUTIVE PAY

Ratios and their use in determining fairness is not a new concept. Thirty-three years ago management expert Peter Drucker wrote an opinion article for *The Wall Street Journal* advocating the use of ratios between executive and non-executive employee pay. Drucker (1977) indicated flexibility in the concept, noting that an appropriate ratio in a small business might be 15-to-1, while in a larger firm 25-to-1 or 30-to-1 might be reasonable. He stated that a ratio of 25-to-1 is "not equality. But it is well within the range most people in this country, including the great majority of rank-and-file workers, consider proper and indeed desirable." He might have meant "fair."

Seven years later, Drucker (1984) again opined in *The Wall Street Journal* that "… the compensation of a tiny group — no more than 1,000 people — at the top of a very small number of giant companies … offend the sense of justice of many, indeed of the majority of management people themselves." He called again for a limit on executive pay as a multiple of pay for the rank-and-file, in the 15-to-1 to 20-to-1 range.

Interestingly, Drucker's latter commentary occurred just as a 14-year stagnation of the stock market was turning into an 18-year bull market that produced executive pay levels unimaginable in 1977 or 1984. Just as a rising tide raises all boats, this same bull market created multitudes of millionaires among those rank-and-file employees too, and thus the question lingered, what is fair?

A FRAMEWORK FOR FAIRNESS

Compensation professionals are now asked not only whether executive pay is competitive, linked to shareholder value, cost-effective, tax efficient and shareholder-friendly, but whether that pay is "fair."

Masson et al. (2009) cited three conceptual aspects of fairness:

1 | **Distributive fairness** — when everyone receives their fair share. This assumes a fixed "pie" with everyone getting their fair slice. The distribution between executives and employees is not the only division — some shareholders and proxy advisors have strict guidelines for how much of the pie can go to employees, through the concept of dilution and the associated metrics of overhang and burn rate (RiskMetrics 2010).

2 | **Procedural fairness** — when the process for allocating pay is effective and transparent. In executive pay, this is the driver behind increased disclosure requirements in SEC filings for public companies and in Form 990 filings for tax-exempt organizations.

3 | **Interactional fairness** — when the condition of people being treated with dignity and respect is applied.

The authors believe that the implicit theme behind the executive pay controversy has roots in each of these.

DISTRIBUTIVE FAIRNESS: INTERNAL PAY EQUITY

Drucker had an immense influence on management practices in the United States and around the world, but on this topic little progress was made. Throughout the 1980s and 1990s, media accounts highlighted the large and growing amounts of pay going to executives of public corporations in the United States. It wasn't until a few years ago, however, that the terms "pay disparity" and "internal pay equity" moved to the forefront of the debate.

Over the past quarter century, the United States has moved from Drucker's sole cry for pay equity to a movement joined by academics, consultants, lawyers, shareholders, proxy advisors, and politicians — including the U.S. president.

This year, a number of public corporations received shareholder proposals that, if approved, would require them to disclose the total compensation packages, including benefits, of their top executives and compare those values to the pay of the company's lowest-paid workers. This parallels the ongoing attitude toward executive pay in the United States, using shareholder pressure and disclosure as the strategy for executive pay reform rather than specific limits. Over the past year, several bills have been introduced in Congress that would require disclosure of and/or set specific pay limits for executives, expressed as a ratio to the lowest-paid worker or the average pay of the company's workforce.

The executive pay equity movement is gaining steam, indicating the need to define what it is before we actually do something about it.

INTERNAL EQUITY FOR CEOS

In the press, internal equity as it relates to CEO pay is defined by the ratio of CEO pay to direct reports or named executive officers (NEOs). When discussed in the context of a broad segment of a company's workforce, the term "internal equity" generally refers to the state of multiple employees receiving comparable pay within a common range of job size, job requirements, experience and performance. These concepts of pay equity are embedded in legislation including: the Equity Pay Act of 1963 (U.S.); Equal Pay Act of 1970 (UK); Directive 2006/54/EC (European Union); and Pay Equity Act (Canada). This is generally a concept of horizontal equity, with pay being comparable among jobs with similar requirements. At the executive level, vertical equity also comes into play.

Many executive jobs are single-incumbent roles — a company has only one CFO, one controller, one general counsel and so on. Multi-incumbent jobs include group or division heads. But the ratio of CEO pay to NEOs is in large part influenced by organization structure. A company with several groups reporting to the CEO versus a company having one COO will find that market values and internal equity ratio calculations will likely differ. Companies traditionally determine internal equity through a combination of job-market pricing and use of a job-evaluation plan that will typically focus on internal job structure in terms of the job's inputs, throughputs and outputs.

Internal equity has in more recent years been defined in terms that go beyond job size and includes criteria such as executive performance and contribution. Executive positions present another challenge to the extent that performance should be a factor in pay determination and an element of equity — not equality — in pay. The bulk of executive pay is determined by performance and most, if not all, of the measurement of performance is based on company and/or business unit results. When pay is primarily determined by company performance, the only lever to pull for internal equity is the relative distribution of annual and long-term incentive opportunity, which leads to further measurement complexities. This highlights the difficulty of attempting to apply fixed standards across industry sectors that have very different pay and performance profiles. Should the best performing CEOs in the companies creating the greatest shareholder value be criticized for having the "highest ratio"?

PAY RATIOS

Still lacking is an empirical basis for determining what is "fair" in executive pay. The difficulties posed by differences in organization size, form of organization and governance, business complexity, organization structure and other factors — many of which were referenced in Drucker's work — call for a methodology that can resolve these questions and turn an emotionally laden debate into a coherent analysis for corporate decision making.

There are a number of reasons that a single ratio, or even range of ratios, cannot be unilaterally applied as a measure of the "fairness" of executive pay.

1 | Company size. There is general agreement that a CEO running a company with $50 billion in revenue and 300,000 employees has a larger, more complex job than the CEO of a company with $1 billion in revenue with 5,000 employees. Hay Group captures this difference in its job measurement methodology through its management breadth and accountability factors. But this influence dissipates further down the organization structure and this effect is not present for most non-executive jobs. The gap between pay of the CEO and a junior accountant at the $1 billion company should not be the same at the $50 billion company. While the ratio can be adjusted based on the revenue factor, other complexities are introduced.

2 | Organization structure. This is an especially critical factor when comparing CEO pay to that of direct reports. In a flat organization structure with a dozen positions reporting to the CEO, one would expect a bigger gap than in a company where there is an heir-apparent COO reporting to the CEO. The same would be true if comparing a company with a functionalized organization structure versus one operating more as a holding company or organized in a matrix structure.

3 | Degree of vertical integration. One of the factors driving organization structure is the business model and degree of vertical integration. A business that is fully vertically integrated with all operational and support functions under one roof will have a very different structure than a virtual firm that outsources production, distribution and many elements of its support functions, such as information technology and human resources.

4 | Degree of global operation. A significant complexity that has not been addressed in the pay ratio discussion is how a globally diverse company would be assessed using a ratio devised from a U.S.-centric perspective. Clearly, a firm with operations in many low-cost countries will likely report a higher CEO-to-worker pay ratio. This, notably, will play to the anti-offshoring sentiment. Not only does the degree of global operation distort the calculation due to differences in labor costs in developed versus emerging economies, but other complexities such as currency fluctuations, level of social benefits and tax rates make this a much more complex topic than is currently acknowledged.

5 | Form of organization and governance. Many discussions of pay ratios assume that all comparators are of similar ownership and governance structure, such as all publicly traded companies. While this group of firms is the easiest basis for debate given the availability of data, it may result in skewed comparisons compared to a company's business competitors, who may be privately held, a wholly-owned subsidiary of a domestic or foreign corporation, joint venture, or pass-through organization, such as a partnership or limited liability company (LLC). This would be of most concern if ratio-based rules make their way into the tax code affecting all corporate filers, rather than merely a disclosure requirement for public companies.

6 | Defining executive positions. Executive pay debates often center on the pay of CEOs, and media attention is typically limited to the "top five" appearing in proxy statements. There are competing definitions of the concept of "executive," "officer," "executive officer," "named executive officer," "covered employee," and "highly compensated" among the various legislative and regulatory standards relevant to executive pay. And there are inconsistencies within individual agencies' various rules. Even if limited to a CEO pay ratio, there are situations such as a chairman paid more than a CEO, the existence of co-CEOs and other complexities.

7 | Defining pay. Analyses of executive-to-worker pay ratios often include an "all-in" definition of executive pay — short-term incentives, long-term incentives, and supplemental benefits and perquisites — and relate that to base salary of workers. Given the relatively minor role of base salary in executive pay and the great variation of pay elements for non-executive workers across industries, it would be necessary to take a total compensation approach.

CEO PAY METRICS

Despite these difficulties in determining appropriate multiples and ratios, these concepts are beginning to make their way into executive compensation culture in the U.S. There are only a few companies that have implemented internal equity guidelines, but two in particular are worth noting to show the variation in methodologies:

- Intel Corporation stated in its 2009 proxy statement, "The committee reviews the compensation of executive officers against the compensation of the top 100 highest paid employees at Intel to monitor internal pay equity. The committee does not use fixed ratios when conducting this analysis, but our CEO's total compensation has typically been 1.5 to 3 times the total compensation paid to each of our executive vice presidents." No mention of these ratios appears in the 2010 proxy statement, only a single comment that "Secondary considerations in determining the level of compensation include internal pay equity" (RiskMetrics).
- Whole Foods Market Inc. states in its 2010 proxy statement that "we endeavor to ensure that our compensation program is perceived as fundamentally fair to all stakeholders" as a prelude to the discussion of the "salary cap" in effect at the company In 2009, the cap was set at 19 times the average annual wage at the company, which was $35,318 resulting in a salary cap of $671,050. The CEO received a salary of $1 in 2008 and 2009 but was the highest paid officer in the 2010 proxy statement (RiskMetrics).

Some corporate governance organizations have adopted the concept directly through adding a metric to their governance rating of companies. Audit Integrity includes the ratio of CEO pay to CFO pay as an element of its Accounting Governance Risk (AGR) rating, which has been empirically validated as more predictive of negative corporate outcomes than other widely-used ratings services (Price et al. 2010).

Unlike Whole Foods' criterion of "fair to all stakeholders," the pay equity movement is primarily focused on shareholder outcomes. This brings us back to the fundamental question about the notion of fairness.

PROCEDURAL FAIRNESS: FAIR TO WHOM?

In the growing body of literature around fairness and equity of executive pay, the prevailing theme is fairness to shareholders — the alignment of executive pay with shareholder value to ensure that shareholders are treated fairly with respect to their returns versus payments to executives.

Many of the ongoing executive pay practice controversies can be construed as being driven by the goal of greater fairness:

1 | Option repricing and exchanges. The practice of repricing stock options, resetting the strike price to a lower point due to a decline in stock price, has widespread opposition and has led to punitive accounting rules and corporate governance policies. Repricing is often considered unfair to shareholders who are unable to reset the price at which they invested in the company while the employee optionees enjoy the value of the stock price's rebound. More prevalent now are option exchanges which often exclude executives and result in employees receiving fewer repriced options.

2 | Option backdating. While the backdating of stock options is not illegal (the improper accounting treatment and related securities filings often were), the tone of the scandal has been "not fair!" — primarily to shareholders who didn't have the opportunity to backdate their purchase price.

3 | Discounted stock options. Another controversial practice is the issuing of options with a strike price discounted below the fair market value on the date of grant. This is deemed "not fair" by many institutional shareholders and proxy advisers who view this as a giveaway to employees and executives not available to outside parties. This view has been reinforced by Section 409A of the Internal Revenue Code, which excludes discounted options from the exemption otherwise available for stock options (U.S. Internal Revenue Service 2010). In addition, Section 162(m) deems such options to be nonperformance based and therefore subject to loss of tax deductibility for grants to the NEOs. Such options are not very prevalent in the marketplace.

4 | Discretionary adjustments to executive incentive pools. After the severe economic crisis beginning in the fourth quarter of 2008, many compensation committees chose to override the formula-driven outcome of executive incentive plans that had produced little or no incentive pool due to the combination of goals that were set pre-crisis and later the business performance levels resulting from the economic downturn. The disclosures surrounding these decisions often emphasized a tone of fairness for the executives who had "done a good job" but were penalized due to results "out of their control." Yet the interpretation by shareholders, advisers, and even employees in some of those companies was that the deal was "not fair" because executives were never asked to give back windfall earnings during the preceding economic boom.

5 | Pay of officers in light of employee pay freezes, pay cuts, layoffs and benefits reductions. During the recent recession, there has been concern over executive pay in companies that produced reasonable business results but had obtained those results from employee layoffs, pay freezes and benefits reductions. The debate centered on whether the executives had done their job by controlling expenses during a business downturn or had just benefited personally from the hardship imposed on employees.

6 | Performance plans. Such plans are becoming more prevalent because they are performance based. Some critics argue, however, that the overall market can impact stock price more significantly than executive performance and that meeting financial objectives such as profitability may come at the expense of employee job loss which in turn negatively impacts future growth prospects. Finally, there is the possibility of plans resulting in significant payouts to executives for achieving financial goals without any accompanying increase in stock price.

These examples highlight another difficulty with the pay ratio approach to equity: It's not always the "how much" but the "how" that is the source of perceived unfairness in executive pay.

INTERACTIONAL FAIRNESS: WHAT ABOUT OTHER STAKEHOLDERS?

Finally, the focus on fairness to shareholders leads to a broader discussion about other stakeholders.

1 | Employees. If executives are overpaid, doesn't that take away from pay available for the rank-and-file for salary increases, benefits funding and retirement-plan contributions? This concern echoes the discussion about executive pay during the recession but points to the broader issue regardless of economic events.

2 | Customers and suppliers. To the extent that executive pay must be recouped through raising prices to customers and/or putting pressure on suppliers to reduce their prices, a pay fairness issue is raised for those parties. It likely is impossible, however, to link an executive pay pass-through effect to these stakeholders.

3 | Taxpayers. While taxpayers may benefit from income taxes paid on executive pay, it comes out of the other pocket as most executive pay is tax-deductible to the company. A significant portion of executive pay in some companies is structured to provide for deferral of taxation, thereby potentially reducing tax revenues on compensation. In addition, the recent taxpayer-funded bailout of teetering financial institutions heightened the awareness of how taxpayer subsidies going to failing financial companies may have been fueled by executive compensation practices with excessive risk. Many citizens view high risk-based pay and protection from failure as "not fair."

MEASURING THE FAIRNESS OF EXECUTIVE PAY

There is no right answer regarding how to measure fairness in executive compensation, but the authors believe that we should examine past attempts at legislating, regulating and lobbying for "fairness" before pursuing some of the ideas being proferred today. If we are headed toward an era of executive pay ratios, there are some principles that can and should be applied as policy positions are developed.

1 | **Focus on job size when scrutinizing pay levels.** Pay should be related to the relationship of job size on an internal basis as well as an external basis. Most companies do not have a formal system for measuring jobs, making analysis and communication of the "adjusted" pay ratio difficult or impossible. If a proxy for job size — such as revenue, market capitalization or number of employees — is used, caution must be exercised in translating scope into size and attempting to apply pay ratios.

2 | **Integrate external competitiveness into notions of fairness.** In the much-publicized Ben and Jerry's pay philosophy, the two owner/founders were paid a small multiple of the entry employee pay. The company had to move away from this philosophy somewhat when going to the outside to recruit, but the fundamental philosophy remained, that of fairness in pay. An integrated market-pricing methodology with a total compensation focus can ensure that a subgroup at the top is not receiving more attention to pay competitiveness than others.

3 | **Consider pay mix and performance as a tool for assessing fairness.** Hay Group's research of Fortune's Most Admired Companies reveals that the most admired are not the highest paid — on salary at least. In fact, Most Admired Company salaries tend to be about 5 percent lower than the rest when compared on the basis of job size. Most Admired Companies tend to grow faster and promote from within more frequently. The authors think is likely due to the fact that responsibilities are increased more quickly and promotions occur more frequently than in other organizations. Further, incentive pay, both short- and long-term, has more value in these companies because of their higher performance.

4 | **Take a long-term view of long-term incentives.** These are valued in most survey and proxy databases based on theoretical fair value on the grant date, not realized gains from these programs. The market volatility of the past two years has created difficulties in measuring the value of equity-based awards that can lead to great distortions in total compensation measurement (Hay Group 2010). Because CEO pay is dominated by equity compensation and in some sectors still dominated by stock options, these complexities must be acknowledged and addressed. Companies that distribute equity compensation to most or all employees will have to consider this in the total compensation ratio analysis.

5 | **Use ratios cautiously.** These may be used as guidelines but not as mechanical tools to manage pay. There is mounting pressure to keep CEO pay reasonable relative to direct reports, and manage pay differences based on the size of the job

relative to direct reports. As was discussed, when comparing ratios across organizations, one must consider organization size, organization structure, governance, business complexity, total compensation design and a host of other factors. To the extent that public disclosure of ratios becomes mandated, these discussions will be a critical investor relations strategy.

CONCLUSION

There is clearly a theme of fairness, or concerns about lack thereof, driving executive compensation trends. But there is no agreement on the definition of "fairness" while there is a widespread belief that arbitrary metrics and ratios may do more harm than good. It is important to relate these developments to those occurring in legislative circles on employee pay and benefits, as these waves often converge and fuel further regulatory action. ∎

AUTHORS

Jim Bowers (jim.bowers@haygroup.com) is a vice president and leader in Hay Group's executive and strategic reward practice. He has broad industry experience, with concentration in life sciences, chemicals, energy and manufacturing sectors. He also leads the North American job-evaluation practice. His consulting focus is to help clients achieve the highest possible return on its HR investment through culture change, performance management and rewards programs. He has written a variety of articles and book chapters on rewards strategy and effectiveness and executive compensation.

Fred Whittlesey, CCP, CEP (fred.whittlesey@haygroup.com) is a senior consultant and leader of the West Coast executive compensation practice at Hay Group. He specializes in compensation strategy, director and executive compensation and equity-based compensation. He has been published in compensation books, journals, periodicals and Web sites and has presented his ideas at conferences around the world. He is co-founder of Global Equity Organization and past Chair of the Advisory Board for the Certified Equity Professional Institute at Santa Clara University.

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