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| HayGroup

CEO Pay Ratio Study

How companies are approaching the upcoming disclosure





Introduction

In August 2015, the Securities and Exchange Commission (SEC) adopted rules requiring almost every public company to disclose the ratio of its Chief Executive Officer (CEO)'s total compensation to the total compensation of its median employee. This ratio (commonly referred to as the "CEO pay ratio") with supporting information will need to be disclosed each year in various SEC filings (e.g., annual proxy statement, certain registration and information statements and annual report).

Data will first have to be compiled for the fiscal year beginning in 2017 for disclosure the next fiscal year. Notably, the CEO pay ratio disclosure will be considered "filed" (rather than merely "furnished") under securities laws which impose liability for misleading statements in SEC filings.

Korn Ferry Hay Group conducted research to:

- understand how prepared companies are for the needed analysis, calculation and disclosure under the SEC's rules on the CEO pay ratio;
- discover which areas, if any, are most concerning for public companies; and
- determine what assistance companies will need with these new analyses, calculations and disclosures.

Highlights of responses and findings

Surveyed companies: In our study, full responses were received from 148 public companies which spanned a broad cross-section of industries and locations of operations. More than two-thirds (68%) of the companies employed fewer than 10,000 employees and approximately 72% of the group reported revenues less than \$5 billion. In general, smaller organizations are less likely to have the internal resources to handle the necessary analyses and determinations.

Involvement of company functions: While we received responses to our study from various internal functions, the two largest groups were Human Resources (35%) and CEOs (28%). Human Resources also was most frequently named as involved with work related to this disclosure and as accountable for such work.

More than one-half (53%) of the companies maintained a single Human Resource Information System (HRIS); this should aid the collection of pay data at these organizations. Companies with multiple HRISs will have the added burden of coordinating information from different systems, which may require external assistance.



Readiness for compliance: We found that just 25% of the respondents were “very clear” on the criteria for the new CEO pay ratio disclosure obligation; most companies (60%) were only “somewhat” clear. On another measure, a mere 13% were actually implementing a plan for compliance with the new requirements, although almost one-half (49%) of the companies were either creating a plan or had agreed to a plan.

These responses show that most of the surveyed companies have, at a minimum, started thinking about how to satisfy the applicable requirements, while also suggesting that many organizations still may require assistance to complete their compliance efforts.

Resourcing the needed work: The vast majority of companies plan to do most of the needed work related to the CEO pay ratio disclosure in-house. 41% of companies anticipate that all of the compliance work will be handled internally and another 51% plan on mostly resourcing the work internally with some external help.

Areas and levels of concern: In our study we obtained information on each respondent’s level of concern (ranging over five gradations from “not at all concerned” to “extremely concerned”; “somewhat concerned” represents the middle level) in various areas relating to the determination and disclosure of a company’s CEO pay ratio:

- A substantial number of companies (45%) were at least “somewhat concerned” with understanding the steps needed to make the disclosure.
- A similar number of organizations (46%) also were at least somewhat concerned with obtaining and collating the needed employee data in connection with the calculation of the CEO pay ratio.
- A little under half of companies (47%) were also somewhat concerned on what to disclose in the various filings.
- A slight majority of companies (51%) indicated that they were at least somewhat concerned with determining the best methodologies (e.g., use of permissible exclusions, statistical sampling, sample size, etc.) to use in data collection and analysis.

The areas discussed in the four preceding bullets are ones where external advisors can be especially helpful.

- Even more troubling to companies was the needed decision making at each step leading to the determination of the final ratio; 53% of the companies were at least somewhat concerned about ensuring that the ratio reflect reality and present the best picture to the public. If a company’s disclosed ratio is substantially greater than its peer group or competitors, the media and labor unions may use it in an attempt to embarrass the company, create a story or pursue their own agendas.
- The impact of the disclosure of a company’s pay ratio on employee perceptions was of particular concern to the responding organizations as



59% were at least somewhat concerned. The potential impact of the pay ratio disclosure on employee morale needs to be addressed as employees will learn what the median employee was paid and whether or not their own compensation was in the top half or bottom half of the workforce.

Likelihood of seeking external support: A notable majority (58%) of companies responded that they were “somewhat likely” to seek external support in connection with the required disclosure and related obligations. When combined with the 11% which were “very likely” to use outside advisors, it appears that most companies (69%) want some guidance in determining and/or disclosing their CEO pay ratio.

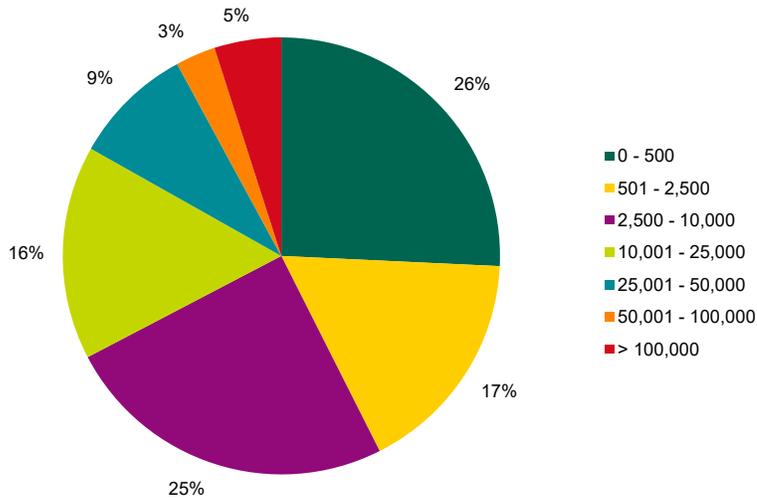
Summary table of responses (most frequent response):

Question	Most frequent response	Page
Q1. Which function will ultimately be accountable for this disclosure?	38%: HR	9
Q2. Which functions will be involved with this disclosure?	77%: HR	9
Q3. How clear is your company on the criteria of this new disclosure?	60%: Somewhat	10
Q4. How prepared is your company to meet these new disclosure rules?	63%: Somewhat	10
Q5. How serious is your company viewing this new disclosure?	51%: Somewhat seriously	11
Q6: How ready is your organizations in regards to a plan to address the new disclosure?	39%: Creating a plan	11
Q7. How do you plan to resource this work?	51%: Mostly internal with some external	12
Q8. Rate each area based on your level of concern from 1 – 5 with 1 being not at all concerned and 5 being very concerned.		
Q8a. Understanding the steps to create the disclosure	33%: Slightly concerned	12
Q8b. Who will do the disclosure	49%: Not at all concerned	13
Q8c. Obtaining and collating the individual employee data	32%: Not at all concerned	13
Q8d. Determining the best methodologies to use (which employees to include/exclude, sample size, statistical sampling, etc.)	32%: Slightly concerned	14
Q8e. Decision making at each step to ensure your final ratio best reflects reality or presents best picture to the public	30%: Slightly concerned / somewhat concerned	14
Q8f. What to disclose in the various filings	36%: Slightly concerned	15
Q8g. Potential for negative press	30%: Slightly concerned	15
Q8h. Impact to employee perceptions	28%: Somewhat concerned	16
Q8i. How likely are you to seek external support for this disclosure?	58%: Somewhat likely	16

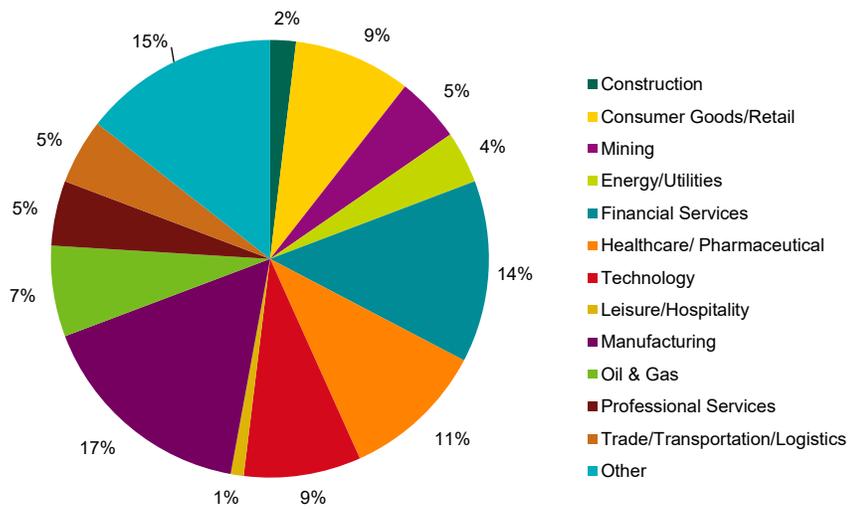


Demographic questions

D1. How many employees are in your company? (n=148)

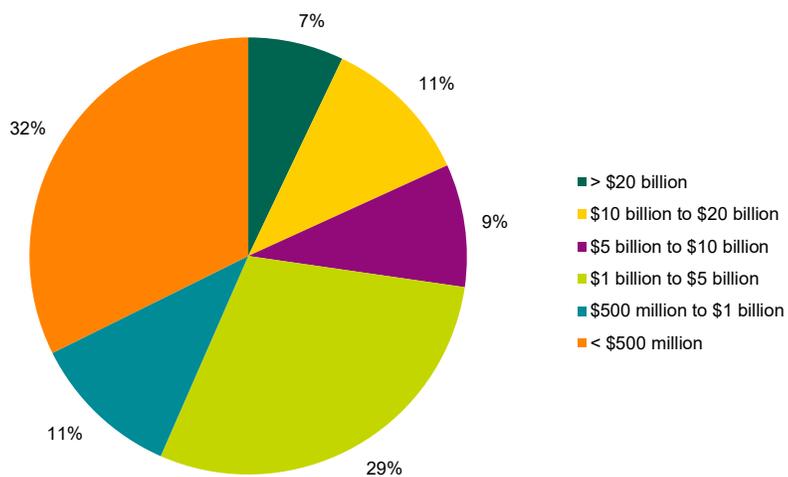


D2. What is the primary industry of your company? (n=148)

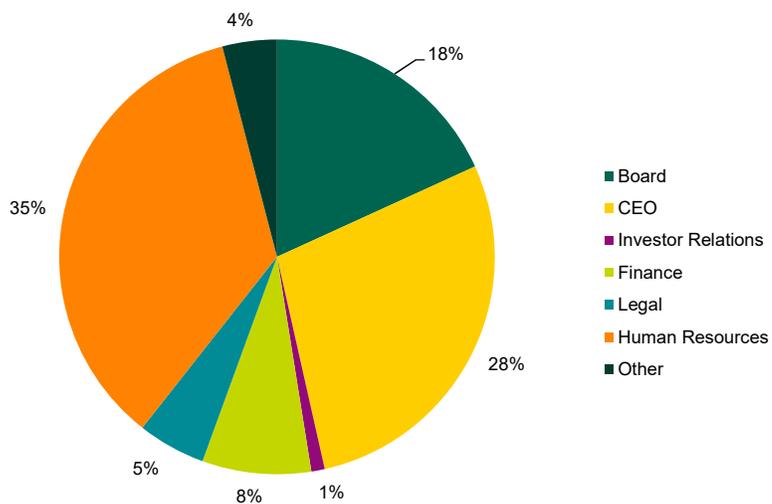




D3. What is your company revenue? (n=148)

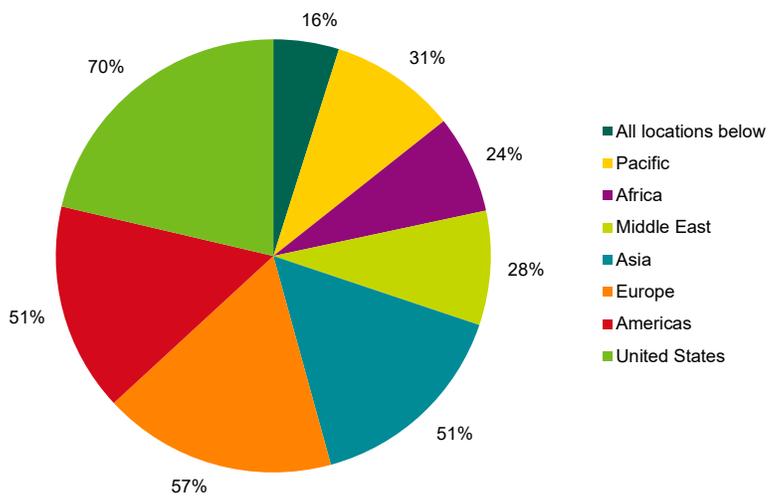


D4. Which function are you part of? (n=148)

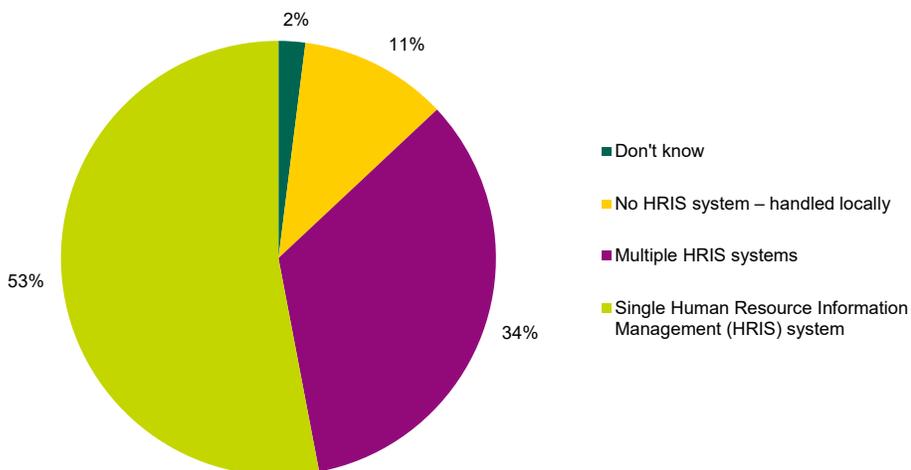




D5. Where does your company operate (choose all that apply)?: (n=148)

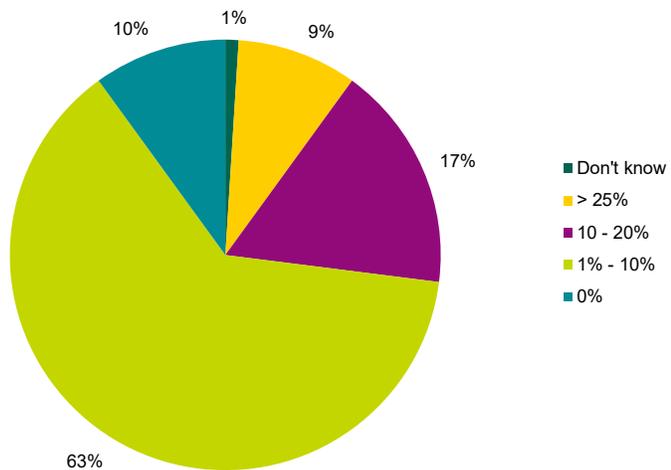


D6. Where does your company store employee compensation information? (n=148)





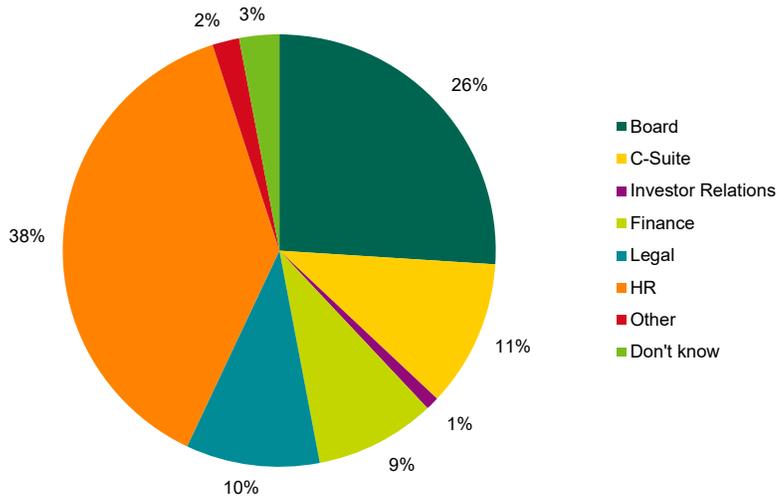
D7. Approximately what percentage of your employees are temporary (contractors, seasonal workers, etc.)? (n=148)



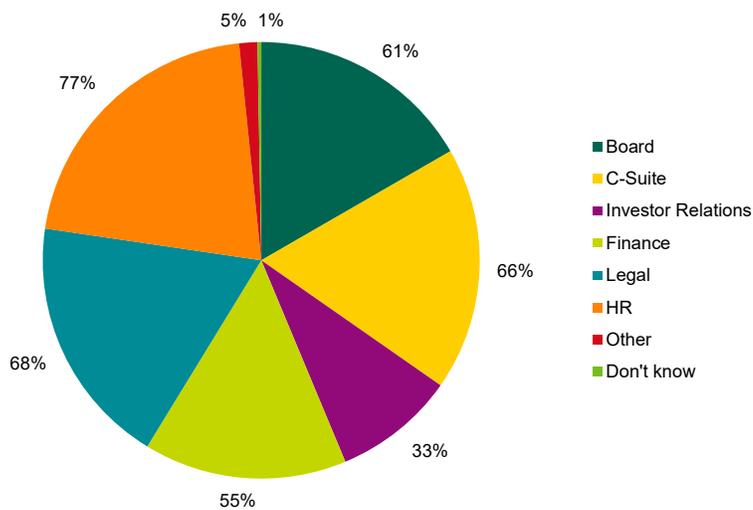


Survey questions

Q1. Which function will ultimately be accountable for this disclosure?
(n=148)

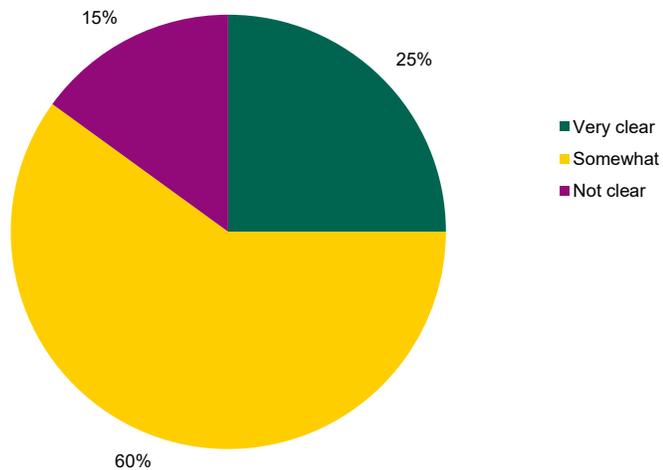


Q2. Which functions will be involved with this disclosure?

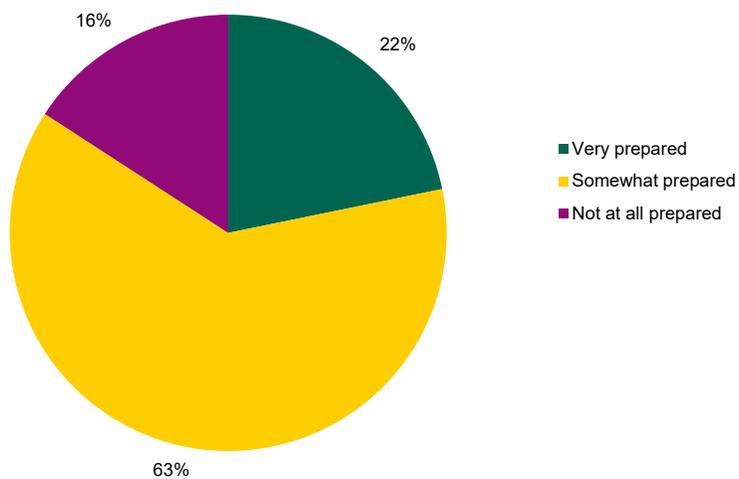




Q3. How clear is your company on the criteria of this new disclosure?
(n=148)

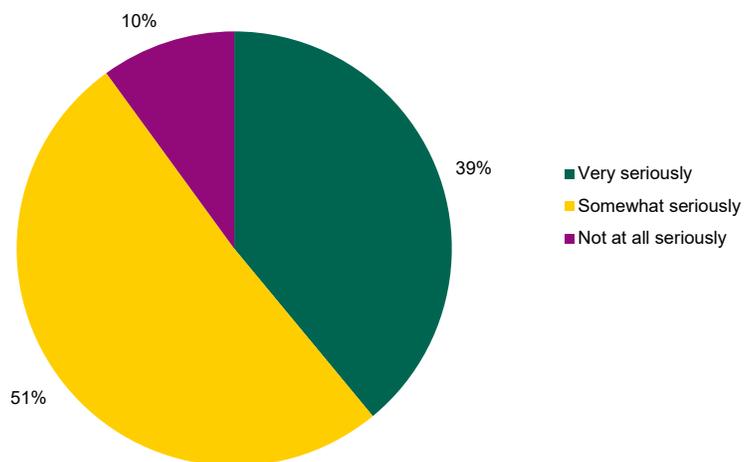


Q4. How prepared is your company to meet these new disclosure rules?
(n=148)

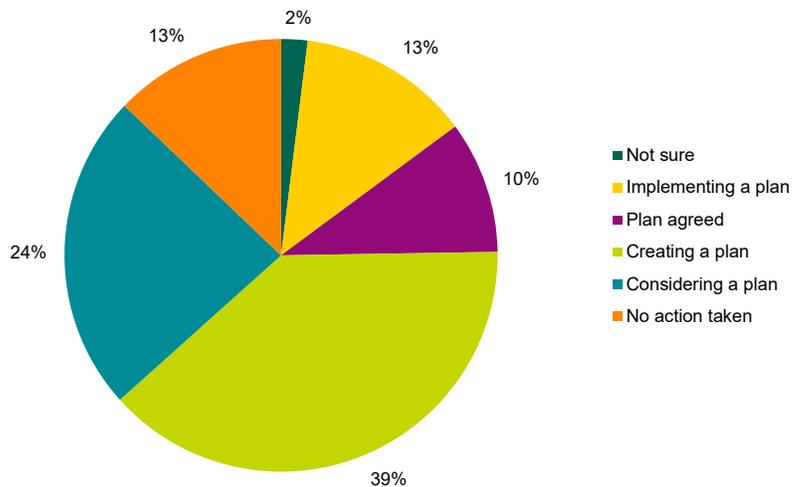




Q5. How serious is your company viewing this new disclosure? (n=148)

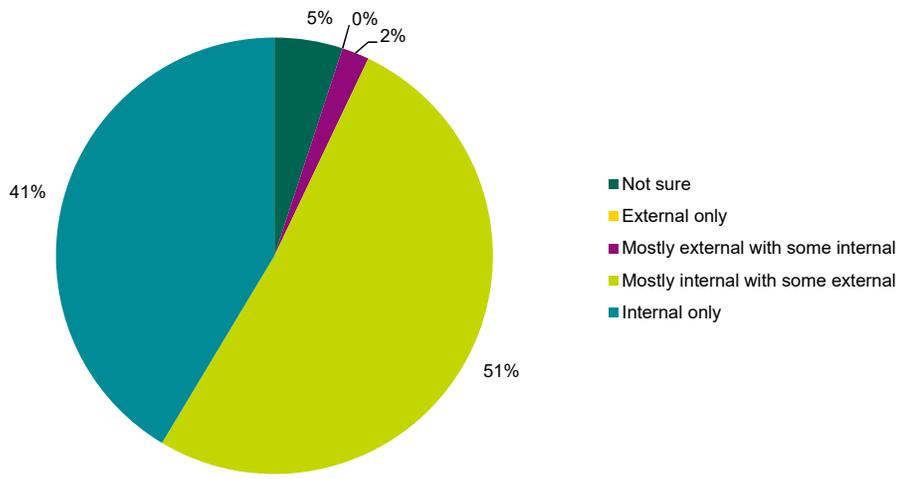


Q6. How ready is your organization in regards to a plan to address the new disclosure? (n=148)



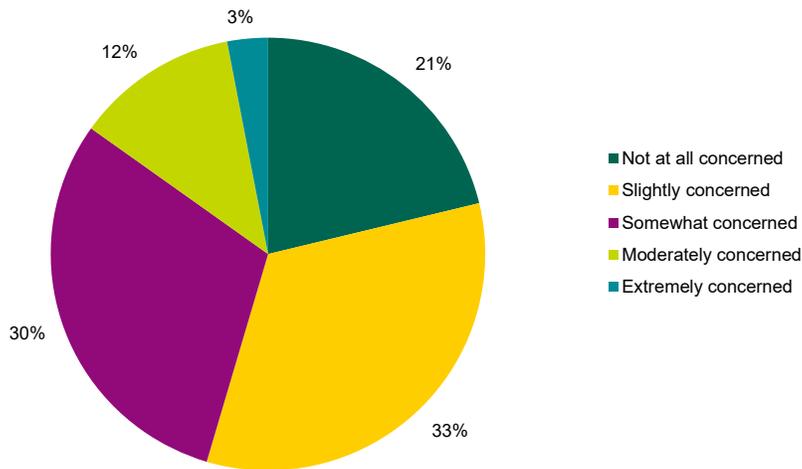


Q7. How do you plan to resource this work? (n=148)



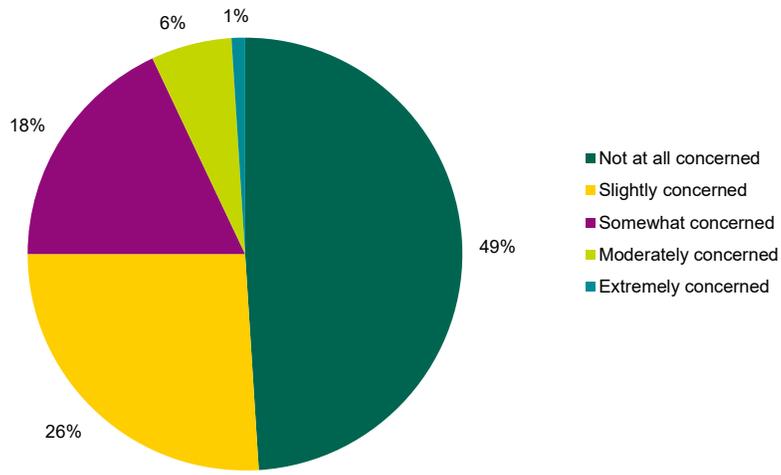
Q8. Rate each area based on your level of concern from 1 - 5 with 1 being not at all concerned and 5 being very concerned.

Q8a. Understanding the steps to create the disclosure

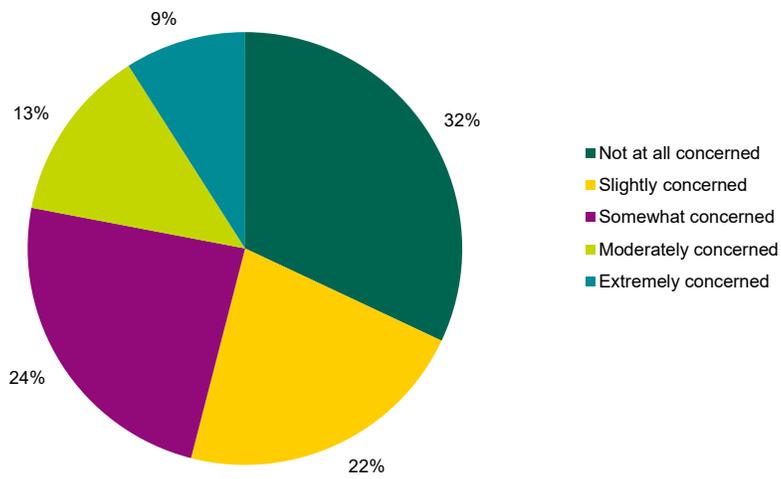




Q8b. Who will do the disclosure?

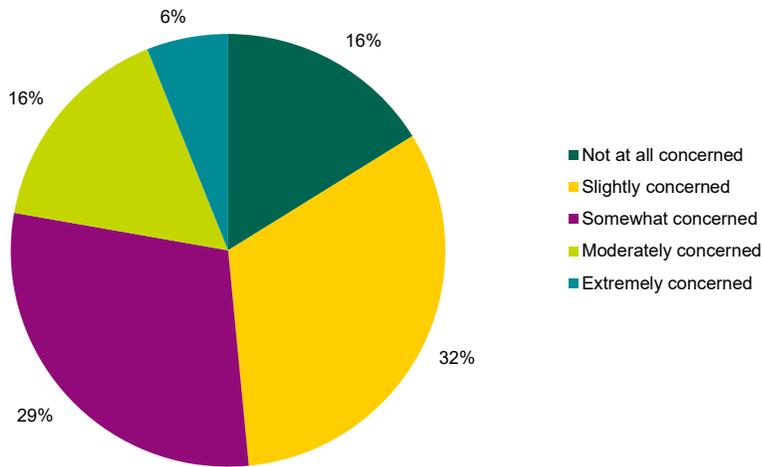


Q8c. Obtaining and collating the individual employee data

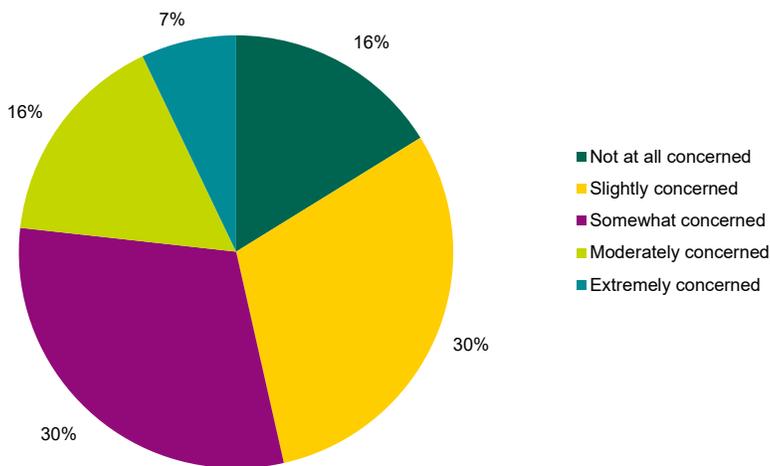




Q8d. Determining the best methodologies to use (which employees to include/exclude, sample size, statistical sampling, etc.)

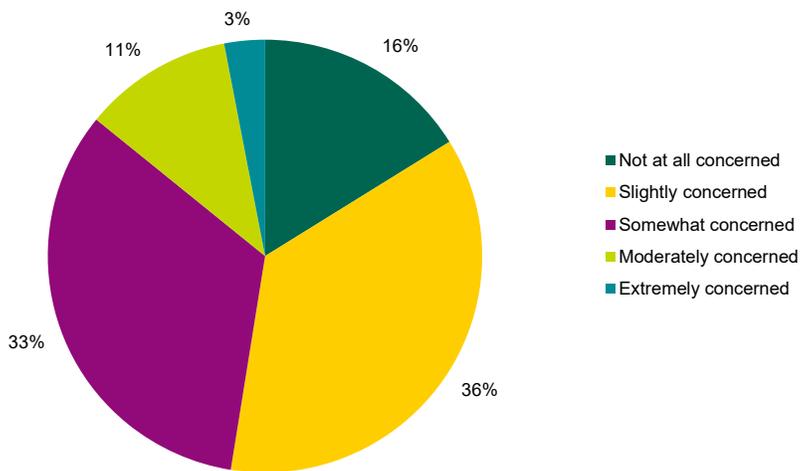


Q8e. Decision making at each step to ensure your final ratio best reflects reality or presents best picture to the public

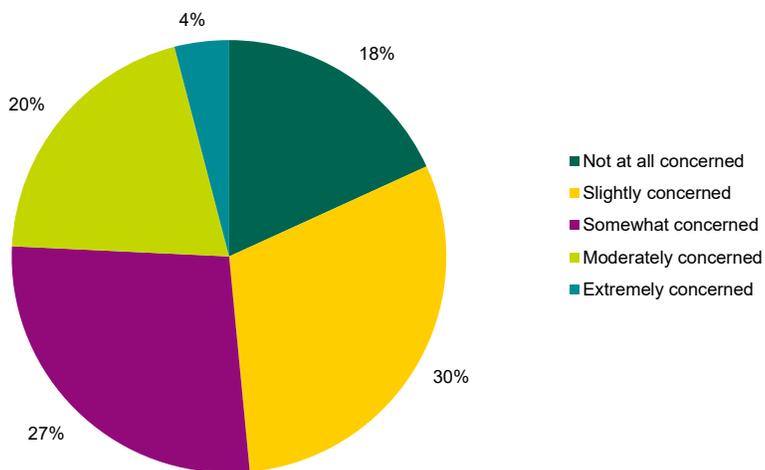




Q8f. What to disclose in the various filings

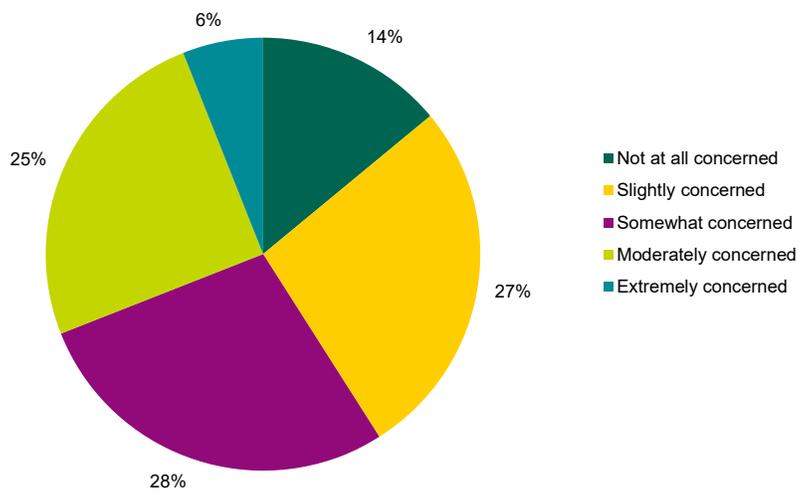


Q8g. Potential for negative press

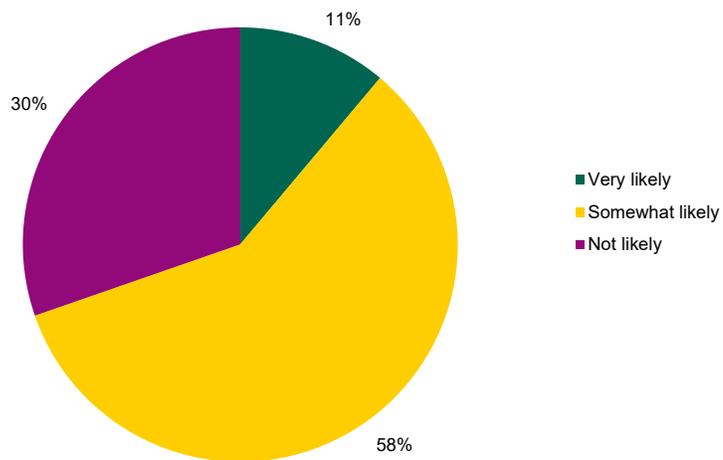




Q8h. Impact to employee perceptions



Q8i. How likely are you to seek external support for this disclosure? (n=148)





What should you do now?

At each company subject to the CEO pay ratio disclosures, a threshold question is how important is being able to report a low ratio. The evaluation of various approaches, exemptions and alternatives (as well as advance testing) may enable a company to disclose a lower ratio, while requiring additional time and expense.

Although no disclosures regarding CEO pay ratios will be required until fiscal years beginning in 2018, next year's (2017) pay data will be used for the needed analyses and determinations. Since the key variable in a company's ratio from year-to-year likely will be the CEO's compensation, it can be informative to look back at fluctuations in CEO pay in recent years.

In any case, the suggested starting point in any analysis of a company's CEO pay ratio is to understand what information may be needed, given the organization's particular facts and circumstances. A working timeline then can be developed that includes action steps (including needed determinations and decisions), responsible parties and target completion dates.

A "dry run" using 2015 compensation data can be performed with appropriate external assistance to test the process, evaluate alternatives and exemptions, and establish a baseline approach that then can be improved upon (such as if another testing is performed after 2016 pay data is available). It also can be useful to develop a draft disclosure (with needed supporting information); this exercise can help a company understand what may be needed to properly explain the results to readers and to provide helpful context (e.g., "the bulk of our workforce was in low wage countries") and rationale.

Who is your "median employee"?

Identifying your company's median employee is needed for the pay ratio analysis, but there are a variety of permitted approaches. Questions to consider include:

- To what extent is the workforce part-time or seasonal, and should this impact the testing date selected?
- What adjustments to payroll and other systems will be needed to implement the relevant determinations, calculations and disclosures?
- Will statistical sampling be helpful (from cost and presentation perspectives)? How large should the sample be?
- What reasonable assumptions should be considered?
- If virtually all of the workforce is in the US, could the 5% *de minimis* exemption apply?
- If non-US employees comprise a significant portion of the workforce, are there any countries where data privacy laws may apply?



- Is the ability to use cost-of-living adjustments for those employees living in a different jurisdiction from the CEO worth the additional time and complexity?

What are some possible auxiliary effects of CEO pay ratio disclosures?

Potential consequences of the disclosures on various stakeholder groups should be considered (e.g., how might a group use the disclosed ratio to attempt to embarrass the company?), along with cost implications (including the time spent by internal personnel). In particular, the impact of the disclosures on employee morale should be evaluated and proactively addressed.

In addition, the new rules are likely to have indirect (and often unintended) consequences. For example, when the disclosures are made, half of the employee population will learn that they are paid below the median employee; human resources should be prepared to address these and other concerns. External resources may be better able to identify such auxiliary consequences of the required disclosures.

Any questions?

If you have any questions relating to our study and its findings, please contact Matt Taylor (Matthew.Taylor@kornferry.com) regarding the study questions and methodology or Bill Gerek (Bill.Gerek@kornferry.com) regarding the study analysis and regulatory issues.

About Korn Ferry

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