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What to Consider When Calculating Your CEO Pay Ratio in Year 2

Deciding whether to re-identify your median employee is a key question going into the second year of pay ratio disclosures. We weigh the pros and cons.

The primary focus for many companies during the first year of calculating the CEO pay ratio was determining what methodology to use when identifying the median employee—ensuring it was both reasonable, accurate, and consistently applied across all employees.

In the second year of pay ratios, new decisions will need to be made, including this all-important question: Should a company identify a new median employee by mandate or voluntary choice? This article will go into greater detail on the circumstances that might trigger a review of your median employee.

Circumstances forcing a company to re-identify the median employee

The CEO pay ratio rule permits the use of a specific median employee for up to three years unless there has been a meaningful change to your employee population, or a change in employee compensation arrangements that the company believes would result in a significant modification to the pay ratio disclosure.

With regards to employee population, the following questions can help determine whether the change to employee population should trigger the re-identification of the median employee:

- Has there been a significant acquisition or divestiture that impacted the employee population?
- Has there been a reduction in force or notable employee turnover during the past year?

However, these questions are not as simple as they may sound, as not all acquisitions or reductions have the same impact. For instance, if a company has 10% overall turnover, with half of the turnover above and half below the median employee, then the change would have a negligible impact on the median employee identification. On the other hand, if a company has spun off a portion of its business, e.g., credit card or mortgage operations, and those employees were among the lowest paid, a new median employee should be identified.

Changes to compensation arrangements that would alter relevancy of the median employee are less likely. Still, they should be considered. The most probable scenario would be if a company either eliminated or introduced a broad-based equity program. Another possible scenario would be a wholesale change from a bonus program based on company performance to one based on individual performance. Ultimately, the question remains: Does the change impact your median employee?

When you should consider re-identifying the median employee

Moving beyond the technical requirements, messaging can play a role in whether a company chooses to re-identify its median employee. While not required to explain any year-over-year fluctuations in the pay ratio or the median employee's compensation, many firms will feel compelled to do so — especially when there are very large fluctuations in the data. For example, if the same median employee is used for the first two years of disclosure and that employee's compensation increased (or decreased) by 4% to 5%, the implication is that all employees' pay increased by a similar amount.

If the same median employee is used in the proxy disclosure for three straight years, the focus of the audience will tend to be on how that individual fared over the three-year period. (Companies are required to calculate the previously identified median employee's annual total compensation for each of the three years). This brings to light several idiosyncratic issues, such as that individual's performance and his or her election of various voluntary company programs like 401(k) contributions or health care that have more to do with an individual's life events than the employer's compensation program. A comparison of an individual's changes in compensation across a three-year period may detract from the purpose of the CEO pay ratio rule, which is to focus on the pay at the 50^{th} percentile and minimize such idiosyncrasies.

What if there is a change in the median employee's status?

If the median employee has left the company or received a significant raise (but there have been no other significant population or pay structure changes), re-identification is not necessary. Instead, the company may simply use another employee whose compensation is comparable to the original median employee based on the compensation measure used to select the original median employee. This substitution must be disclosed in the proxy statement.

In practice, this means going back to the original dataset, identifying an employee in closest proximity to the originally identified median employee, and calculating the actual annual total compensation for the new individual. To be conservative, it is worthwhile to perform this exercise for several individuals, as it is likely that most employees' compensation would change each year. It is important to ensure that the substitute median employee's compensation remains representative after factoring in compensation adjustments.

Substitution can only be used if it is just a change in the particular employee's compensation that makes the specific employee no longer representative. When it is a change to the population, re-identification is explicitly required.

What's next

While many key decisions relating to the CEO pay ratio calculation and disclosure have already occurred in the first year of disclosures, a new set of challenges remains in year two. The decision as to whether a firm must, or should, re-identify the median employee may be evaluated both quantitatively and qualitatively, placing the appropriate weight on cost-benefit considerations and how the data will be perceived by stakeholders in the proxy.

To learn more about the CEO pay ratio and what to expect in year 2, please contact our team.

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