PAY RATIOS

JUST DO IT

PAUL MARSLAND

high pay centre

About the High Pay Centre

The High Pay Centre is an independent, non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

@highpaycentre
www.highpaycentre.org

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Stefan Stern

John (now Lord) Monks, former general secretary of the TUC, once asked a very good question: "How do you shame people who are shameless?" He was speaking in response to my hopeful inquiry – could the shame mechanism still be used to exert downward pressure on excessive pay deals at the top of businesses? This was nine years ago. Looking back, you would have to say that Monks's scepticism was justified and my tentative hopefulness naïve.

Pay ratios – revealing the gap between what is paid at the top and the middle of a business – could help bring back at least a modicum of shame or embarrassment into our boardrooms. This would be a healthy development.

But there are other reasons why pay ratios could help improve not merely business's reputation but how they actually perform. If top pay in some companies has spiralled out of control it needs to be brought back into contact with the rest of the workforce. Pay ratios can help achieve this. The adoption of a pay ratio automatically integrates pay at the top of listed companies into an organisation's formal pay scale.

If we really want to be "all in this together", to use a phrase that has sadly fallen into abeyance, a narrower gap between pay at the top and what the rest of the organisation receives would be a positive sign. It would show that, as employees, we are involved in the same fundamental task, that we have a common purpose. The impact on morale and motivation levels could be powerful.

Business leaders have long declared: "If you cannot measure it you cannot manage it". If we really want to do something about damaging pay inequality then we should be measuring it. This is where pay ratios come in. This report, by Paul Marsland, deputy director of the High Pay Centre, makes a convincing case for them.

Stefan Stern is director of the High Pay Centre

Executive summary

There is great value in identifying what the pay ratio is between the top and the median in a business or organisation. Relativities matter. This is the sort of benchmark that can help businesses manage their position on pay.

Welcome moves at the bottom end of the income distribution may have a positive impact on pay ratios. But we will only be able to track progress if pay ratios become a more prominent element in the continuing debate on pay and inequality.

If it really is "difficult" or "onerous" to report on pay ratios this would suggest employers have inadequate data on pay levels within the business. This is data they should have, and calculating the ratio ought not to challenge anybody with a decent pass in O level/GCSE maths.

Care will have to be taken in identifying the comparator group of employees against which the pay ratio will be calculated. The outsourcing of staff and growing use of flexible labour ("zero hours contracts") may distort calculations. Companies should use clear and consistent employee group comparators.

However, in the UK the mandatory disclosure of average number of employees and employee costs should allow for a simple and straightforward calculation to produce the average employee element of a CEO to average employee pay ratio. When this number is divided into the CEO single figure (a figure for which the calculation is already prescribed by statutory regulations) a simple pay ratio is produced. No additional costs need be incurred by UK companies to produce this figure.

As part of calculating CEO pay accurately, some of the extraordinary "riders" (or perks) awarded to some CEOs (see page 31) should be noted. These are privileges not afforded to ordinary employees and are part of the overall pay ratio story.

Equally, differing pension arrangements may not show up in a formal pay ratio. The move away from defined benefit (DB) schemes has shifted investment risk from the corporate sector to the individual. The relative risks faced by a CEO participating in a DB scheme and employees participating in a defined contribution scheme (or vice-versa) will not be reflected in a pay ratio.

Some argue that the pay gap provides an incentive to rise up the career ladder and raise performance levels. If pay differentials are to be justified by reference to their motivational effect the differences must be known in order to draw any conclusions. This is what pay ratios reveal.

If top pay in some companies has spiralled out of control it needs to be brought back into contact with the rest of the workforce. Pay ratios can help achieve this. The adoption of a pay ratio automatically integrates pay at the top of listed companies into an organisation's formal pay scale.

Give shame a chance: some of the opposition to pay ratios obscures a fear amongst employers of having to justify pay differentials between those at the top of a company and the rest of the workforce by reference to objective criteria. But public companies should be able to justify how pay levels are set.

No two companies are the same. In essence a pay ratio forms just one part of a range of information which companies are able to make available with regard to their human capital.

Introduction

There is neither a unique purpose nor a single measure for a pay ratio. This paper will argue that there is, however, value in knowing what the ratio of pay at the top of an organisation is to pay lower down. This value depends on the desired objective: whether it is to demonstrate that employee pay, regardless of whether it is at the top or bottom of an organisation, belongs on the same spectrum or to reveal the role that human capital plays in the business model. To deny that any such ratio has value is to deny that the human capital in a business should be subject to relative performance measurement, just as financial capital is. Denying that pay ratios have meaning wilfully ignores the existence of corporate culture and the role played by the tone set at the top.

If pay ratios have value then it is worth investigating how such a ratio might be constructed. This paper looks at the components and how each element of a ratio might be defined. ■

The economic background

The answer as to why we need pay ratios lies partly in the failure of the changes in the UK's income distribution and changes in the UK's listed sector income distribution to act in the UK's economic interests. A current government priority is to address the problems posed by a low wage, low productivity economy. This is the first time in living memory that the UK has experienced these economic conditions. Recent years (2007-2014) have seen a continuous fall in real wages, something last seen in the 1930s.`

Real wages fell by over 8% between 2007 and 2014. The decline in living standards in recent years has taken place against a background of an ever declining proportion of national income going to employees. This steady decline has been apparent since the early 1970s.

In tandem with what the TUC refers to as the "earnings crisis" labour productivity has stagnated and has yet to recover to levels recorded for 2008.

One of the moving parts in any pay ratio is the lower of the two pay elements being compared. The government has stated its view that improved productivity ought to result in improved pay at the lower end of the income distribution.

table 01 **Comparison of periods of significant falls in real wages**

	1865-67	1874-78	1921-23	1976-77	2007-14
Duration (years)	2	4	2	2	7
Depth (%)	-10	-1.7	-8.2	-6.6	-8.2
Recovery (%)	+12.8	+0.6	+4.5	+14.5	N/A
Total change over seven years (%)	+1.2	-1.1	-4.0	+6.9	-8.2

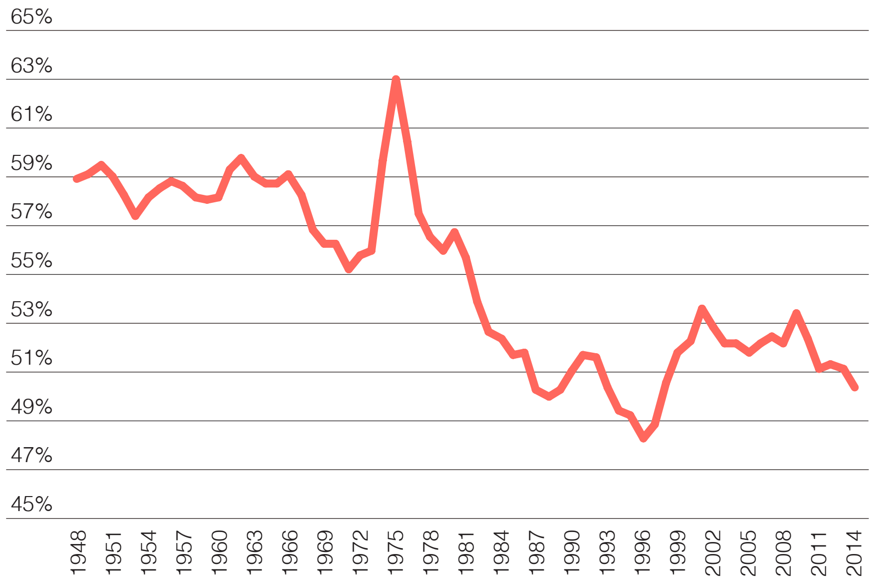
Sourced from TUC: https://www.tuc.org.uk/economic-issues/labour-market-and-economic-reports/economic-analysis/britain-needs-pay-rise/uk

"While productivity growth is key to ensuring that real wages rise across the economy, the government believes that now is the right time to take further action to tackle low pay to ensure that low wage workers can take a greater share of the gains from growth."

HM Treasury: Fixing the Foundations, Creating a More Prosperous Nation, CM 9098, July 2015 Section B 10.8

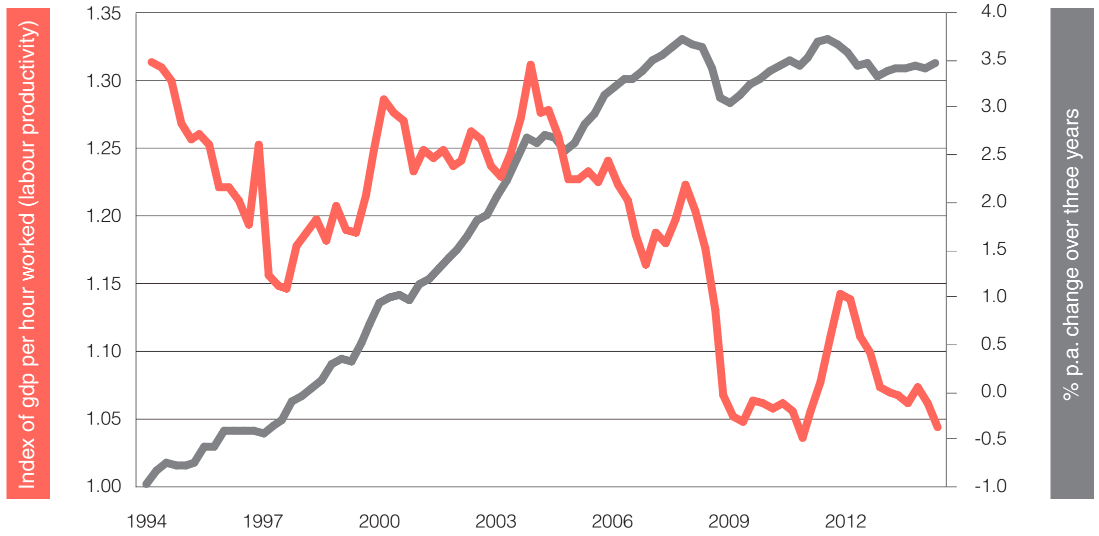
Arguments about how much represents a fair share of the "gains from growth" presuppose that there is growth in the first place. At a national level there are signs of a gentle rise in recent months but it is still well off the historical trend. Despite this pay at public companies and in particular pay at the top of public companies has accelerated. ■

figure 01 **Employee Wage Share % GDP (excl. self employed) 1948-2014**



Data Source ONS: UK Output, Income and Expenditure - Gross domestic product by category of income: current prices

figure 02 **UK Labour Productivity 1994-2014**



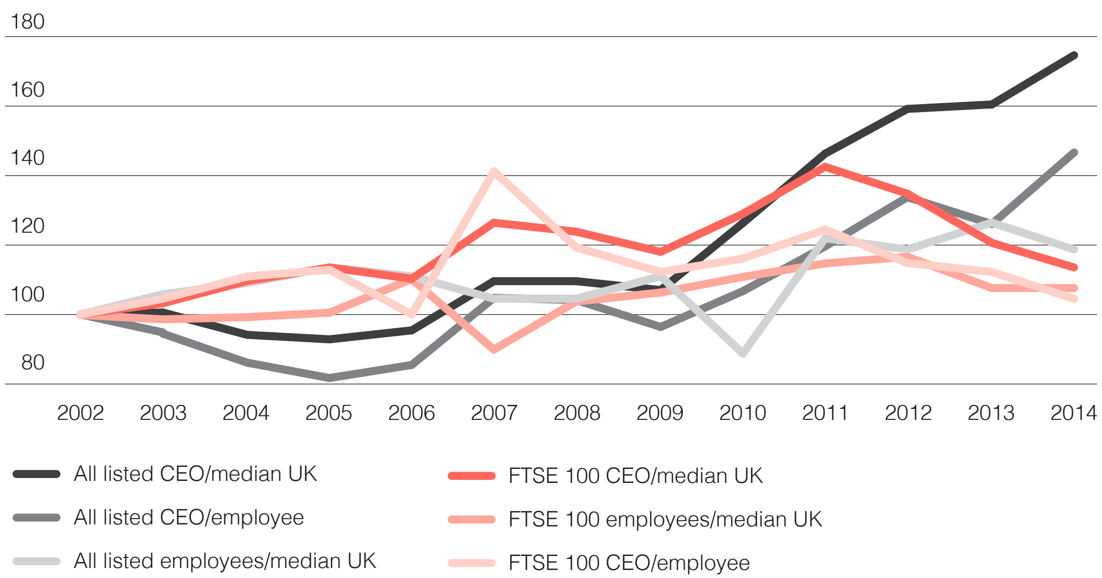
Source: ONS/Andrew Smithers (rebased 1994 =1)

1. A growing gap - on any measure

Levels of pay in the economy generally remain detached from levels of pay experienced by those working at the UK's listed companies. Although this gap has narrowed in more recent years it remains true that that the gap in pay between CEOs and employees in the same organisation has widened since 2002 whether measured using the FTSE 100 or the FTSE All Share index, plus AIM listed companies. However, the most notable widening of the pay gap in this period has been between the CEOs of listed companies and the typical UK employee.

Shareholders of quoted companies were given the right to vote on directors' remuneration as a separate agenda item for the first time in 2002. The vote was an advisory vote and not binding on the company. ■

figure 03 **Growth in pay gap on all measures since 2002**



Source: ONS/High Pay Centre /Manifest (rebased 2002 =100)

2. Pay ratios - the inputs

It has taken US regulators five years of wrangling to agree the inputs for the recently introduced pay ratio disclosure rule. The delay between adoption of legislation and adoption of a regulatory disclosure requirement in the US was not simply a reflection of the technical hurdles to collating data needed to report the proposed CEO to median ratio. There remains strongly felt opposition to ratio reporting.

Attempts are now being made by members of the House Financial Services Committee to repeal the recently introduced final rule using a device called the Burdensome Data Collection Relief Act.

The name of the device being used gives a clue as to the perceived problem. Some US companies have admitted to difficulties in compiling payroll data. In a public comment regarding the proposed rule submitted to the SEC in July 2015, John Hayes, the chairman of the governance committee of the Business Roundtable (an association of CEOs for large US companies) states that:

"The vast majority of private sector companies lack an easy and efficient way to gather compensation data from operating divisions around the world, since they use a wide range of different and often incompatible payroll systems"[1]

In the UK context total employee remuneration is a required disclosure under company law. In the US context it is difficult to reconcile the Business Roundtable statement with the fact that US companies report both their number of employees and payroll costs in the 10 k filings submitted to the SEC, although it is worth noting that companies frequently refer to an "approximate" number of employees in these filings. The public reaction of US companies to pay ratio disclosure – that it is difficult to compile pay roll data – exposes the possibility that listed companies do not have a handle on what is their most significant cost. This is a greater governance concern than the ability of companies to reveal such costs in a pay ratio.

2.1 The CEO

In adopting a ratio a company or regulator must of course first decide which constituents of its

[1] https://www.sec.gov/comments/s7-07-13/s70713-1573.pdf

payroll are to be compared. At the top end of a company's income distribution: should this be the directors? The executive directors? The executive management? The senior management team? All of these are valid candidates for pay comparison. However, all suffer from the same disadvantage, namely, complexity. It is no accident that in almost every scenario in which a pay ratio has been adopted the top end of the ratio is represented by the CEO.

The arguments around using pay of a single person at the top of an organisation to inform a ratio were rehearsed by the Hutton Review[2], which rejected the use of the prime minister's pay in a ratio for public sector pay. Hutton considered that the lack of a market place for prime ministerial pay ruled it out as a suitable benchmark.

A similar claim can be made for CEO pay to which most ratios are anchored. The candidates are selected by the employer and do not respond to open advertising of a position. The lack of a formal job description is another of Hutton's arguments. This applies here too. There is of course a difference between a properly functioning market and no market at all. Using CEO pay is an easily accessible low cost option, and the perceived flaws in the way in which such pay is set could and should be addressed by subjecting CEO pay to the same market forces that apply lower down the income distribution.

The chart above uses total remuneration awarded in order to quantify CEO pay. The table below shows how this measure differs from the government's official measure of CEO pay (the single figure). It is also possible to express CEO pay as the amount which is actually paid or realised:

The malleability of pay ratios starts to become apparent when different measures are used for the inputs.

The average pay of a FTSE 100 CEO has risen since the financial crisis on any measure, but on all three measures the ratio between CEO and average employee has narrowed in the period since 2009. However, the most current ratio of CEO to employee pay (2014) is very different depending on the measure used.

With so much variance between the figures for CEO pay since 2009 it begs the question of which figures shareholders have been using when approving directors' remuneration, and which figures companies themselves use when benchmarking pay against index or peer group to determine whether increases are justifiable. Given the prominence of the

[2] Hutton Fair Pay Review March 2011 http://webarchive.nationalarchives.gov.uk/20130129110402/http:/www.hm-treasury.gov.uk/d/hutton_fair-pay_review.pdf

table 02 **Three different measures for CEO pay**

"Total Remuneration Awarded" comprises:	"Single Figure" comprises:	"Realised" comprises
All fixed cash payments in the year including salary	The total amount of salary and fees	All fixed cash payments in the year including salary
All taxable benefits	All taxable benefits	All taxable benefits
Cash bonus paid or receivable in respect of performance in the year	Money (or other assets) received or receivable as a result of achieving performance conditions relating to a period ending in that financial year except where such awards made in a previous financial year or where awards subject to peformance conditions in a future financial year – ie annual bonus	Cash bonus paid or receivable in respect of performance in the year
Expected value of deferred bonus awarded in respect of the year under review		The gain from incentive awards that vest in the year including any gain from options exercised in the year rather than assumed gain from options exercisable in the year. Excludes estimates and expected value of deferred bonus or other share awards.
Expected value of incentive awards awarded in the year	Money (or other assets) received or receivable from multi year performance based awards where final vesting is determined by performance measures relating to a period ending in the relevant financial year – realisable amount from previous years LTIP or option award	
Value of pension accrued or provided in the year	All pension related benefits including all payment in lieu of retirement benefit and benefits in the year	Value of pension accrued or provided in the year

Sourced from TUC: https://www.tuc.org.uk/economic-issues/labour-market-and-economic-reports/economic-analysis/britain-needs-pay-rise/uk

table 03a **FTSE 100 CEO to average employee pay ratios – single figure**

Year	CEO single figure of total remuneration average of FTSE 100	Average employee earnings	CEO single figure of total remuneration as multiple of average employee earnings
2009	£4,223,914	£32,521	130
2010	£4,729,560	£34,176	138
2011	£4,429,698	£35,744	124
2012	£4,574,875	£36,672	125
2013	£4,708,261	£34,482	137
2014	£4,364,247	£34,846	125

Source: Manifest

table 03b **FTSE 100 CEO to average employee pay ratios – awarded**

Year	CEO total remuneration realised	Average employee earnings	CEO total remuneration realised as multiple of average employee earnings
2009	£4,932,954	£32,521	152
2010	£4,518,812	£34,176	132
2011	£4,200,000	£35,744	118
2012	£4,193,395	£36,672	114
2013	£4,323,221	£34,482	125
2014	£5,212,415	£34,846	150

Source: Manifest

table 03c **FTSE 100 CEO to average employee pay ratios – realised**

Year	CEO total remuneration awarded	Average employee earnings	CEO total remuneration awarded as multiple of average employee earnings
2009	£3,895,000	£32,521	120
2010	£4,254,000	£34,176	124
2011	£4,771,777	£35,744	133
2012	£4,534,228	£36,672	124
2013	£4,156,438	£34,482	121
2014	£3,929,596	£34,846	113

Source: Manifest

single figure measure due to its inclusion in mandatory reporting requirements it seems likely that this is what shareholders have been signing off. If so shareholders have tolerated a fluctuating pay gap at listed companies in the years since the financial crisis.

2.2 Median versus Average

We can see that the rate of pay at the top has gone up faster than for average employees since the introduction of a direct shareholder vote, but without any disclosure by companies, which details how rates of pay are affected above and below the median for their income distribution, it is not possible to say if the changes that are identifiable in average employee pay are as a result of changes to high or low pay. Without this disclosure there remains a risk that investors are unaware of a growing gap between pay at the top of companies and the typical pay of employees in the same organisation. The absence of this information also obscures the extent to which the trend in typical pay at listed companies reflects the trend in typical UK pay.

Figures for the pay of individual executive directors are required to be disclosed by UK companies.

table 04 **CEO to other executive ratio FTSE 100 and All Share by year Median/Mean**

Year	FTSE 100 annual average	FTSE 100 annual median	All Share annual average	All Share annual median
2002	2.18	1.86	1.94	1.61
2003	2.54	2.09	1.97	1.64
2004	2.55	1.92	2.11	1.60
2005	2.35	1.80	1.98	1.55
2006	2.35	1.93	1.95	1.57
2007	2.18	1.90	1.97	1.57
2008	2.69	1.69	2.00	1.54
2009	2.55	1.84	2.03	1.55
2010	2.16	1.79	1.97	1.56
2011	2.08	1.83	2.12	1.57
2012	2.25	1.82	2.83	1.58
2013	2.18	1.86	2.10	1.62
2014	2.74	1.94	2.11	1.60

Source: Manifest

Using the figures disclosed for individual executive directors and comparing each to the relevant CEO pay for each FTSE 100 (in this case CEO "received" pay), it is possible to illustrate the impact of choosing average rather than median. The same calculation might be applied at a company level. The number of executives whose pay figures contribute to the calculation is defined by executives whose pay was individually disclosed for the relevant financial period, and is not an average number such as that used to report employee numbers for the purposes of the Companies Act.

For either FTSE 100 or all listed companies the ratio of CEO to mean (average) for other executive directors is higher than the ratio of CEO to median for other executive directors. However the distance between the two ratios should not be interpreted as an indication that pay is becoming more or less fairly distributed. Rises below or above median of the income distribution can increase the gap between a ratio of CEO/Average and a ratio of CEO/Median.

There is merit in the current UK legal disclosure regime which requires companies to report average employee costs and numbers. The value reported represents the actual direct labour costs borne by the company for producing its goods or services. Movements in this figure such as those expected following introduction of the new National Living Wage rising from £7.20 an hour to £9 an hour by 2020 are clearly relevant to investors. However, the average on its own says nothing about the extremes. Extremities are present in listed company income distribution, from tens of millions to less than £14,000 per annum for a UK full time employee at current minimum wage or less for some overseas employees.

The determinants of income at both high and low extremities are likely to be different to those which inform pay levels at the median. Amongst low paid employees there may be an unwillingness to accept small increases which trigger loss of benefits, such as tax credits, or which require extra time commitments for which additional income doesn't compensate for resulting childcare or other care costs. Pay levels amongst the highest paid executives may be insulated from normal supply and demand by a lack of open advertising and the involvement of recruitment "headhunters".

Disclosure of a median alongside the mean would allow investors and other readers of the annual report to observe whether typical income – which is subject to normal market forces – was becoming more or less detached from top pay over time.

The idea of "normal market forces" assumes a single labour market. Although such a market might arguably exist within the EU member states it cannot be assumed to exist across all the markets in which UK listed companies operate. The country in which an employee is based is a strong determinant of pay level, and the multi-national nature of large listed company workforces is perhaps the biggest contributor to intra group pay gaps. The role played by different country norms, and the extent to which this has an impact on the utility of a pay ratio, is significant for widely dispersed workforces. Some large cap UK groups have employees and operations in well over 100 countries.

In such cases additional information is needed to give context to a pay ratio.

Since January 2015 Article 89 of the EU Capital Requirements Directive CRD IV has required EU member state financial institutions to disclose number of employees

> *"by member state and by third country in which it has an establishment"*

It is worth noting that this requirement is explicitly to disclose Full Time Equivalent (FTE) and not total headcount. This may be contributing to the poor levels of compliance with s 411 of CA 2006.

Some UK companies already voluntarily provide a number for UK employees. For those companies which go beyond minimum disclosures in this area and choose to break down staff costs investors are able to judge how pay is framed in the context of the wider UK market.

Company by company exposure to market norms is useful information for investors. The Resolution Foundation estimates that by 2020 the "National Living Wage" will add £4.5bn to the wage bill of British firms.[3]

Disclosure rules which were introduced in 2013 for UK listed companies already require companies to indicate the percentage change in salary for both the CEO and employees over the reporting period.

Sch.8:19. (1) The directors' remuneration report must set out (in a manner which permits comparison) in relation to each of the kinds of remuneration required to be set out in each of the columns headed "a", "b" and "c" of the single total figure table the following information— a) the percentage change from the financial year preceding the relevant financial year in respect of the director undertaking the role of the chief executive officer; and b) the average percentage change from the financial year preceding the relevant financial year in respect of the employees of the company taken as a whole

The narrow focus of this comparison makes it a poor basis for judging whether implementation of remuneration policy in the year has resulted in fairer income distribution.

In tandem with the reporting of percentage changes in fixed pay, the 2013 regulations also require companies to consider pay elsewhere in the company when determining executive pay levels.[4]

Regulatory Requirement Sch.8:38. The directors' remuneration policy must contain a statement of how pay and employment conditions of employees (other than directors) of the company and, where the company is a parent company, of the group of other undertakings within the same group as the company, were taken into account when setting the policy for directors' remuneration.

This requirement is not well observed. The regulations are clear that disclosures should provide some explanation as to how wider conditions are taken into account. Despite this clarity many companies fail to explain how employee pay was taken into account when setting directors' pay. A government report on compliance with the new regulations, published in March 2015, cited evidence that some companies made no statement or mention at all of the consideration of workforce pay in setting directors' pay, whilst a significant proportion of companies in the sample failed to say how pay elsewhere in the workforce was taken into account. The inclusion of reference to an internal pay ratio during consideration of directors' remuneration would be one way of satisfying this requirement.[5]

2.3 The employees

Common sense dictates that income comparison within an organisation is best done using that organisation's employees. However, there is a growing possibility that people who are dependent on a single organisation for a regular income are not defined as employees.

The ONS August 2014 data release on self-employed workers shows that self-employment is now higher than at any point over the last 40 years. Another notable trend revealed by the data shows that the average income from self-employment has fallen by 22% since 2008/9. The ONS categorises occupations amongst this self-employed group. Taxi drivers form the second largest category. It is taxi drivers that are the subject of the current legal battles to reclassify independent contractors as employees.

If the average pay for independent contractors is the same as for employees this classification should make little difference to a ratio of CEO to average employee. However, in cases where re-classification has been the subject of litigation, for example action against Uber in the United States, the claim is that drivers who are not classified as employees are denied expenses such as petrol and vehicle maintainence, which is typically paid to employees. Clearly the exclusion of lower paid workers from a calculation narrows

[3] http://www.resolutionfoundation.org/publications/taking-up-the-floor-exploring-the-impact-of-the-national-living-wage-on-employers/
[4] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf
[5] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/409714/bis-15-168-Directors-reforms-how-companies-and-shareholders-are-responding.pdf

the resulting ratio and provides a less meaningful picture of the pay at the top of an organisation in the context of the labour costs it incurs in delivering its services.

Under the new US rule workers contracted to unaffiliated subsidiaries are excluded from the ratio. Considering exclusion of certain parts of the workforce is a legitimate exercise. The principle example of a large company which has adopted and uses a pay ratio in the UK is the John Lewis Partnership, an employee owned retail business with 93,800 employees. Rule 63 of the John Lewis Partnership constitution states that the pay of the highest paid partner will be no more than 75 times the average basic pay of **non-management partners**, calculated on an hourly basis. Exclusion of staff with a supervisory role from the ratio clearly has the opposite effect to the exclusion of lower paid workers through employee classification. The widening of a ratio for which the calculation is discretionary suggests that John Lewis does not regard its ratio as a public relations exercise, and that the ratio is intended instead to help deliver on the purpose of the organisation as enshrined by its formal constitution.

The ease with which a company can transfer employees in or out of employee status whilst continuing to rely on their efforts to produce its goods or services presents an obvious risk to the credibility and usefulness of an employee based pay ratio. Indeed, this risk is considered so great by some commentators that it is used as an argument against introducing them. It seems clear that where flexibility to exclude employees is allowed improved human capital disclosure of the kind already practised by John Lewis and called for by the Pensions and Lifetime Savings Association (PLSA formerly the NAPF) in its recent "Where is the workforce?" report would allow listed companies to mitigate this concern. The clear disclosure of how each element of a ratio is defined is critical to overcoming this objection.

The issue of who to include in a ratio and who to exclude was the focus of many of the public comments submitted to the SEC during the consultation on their proposed pay ratio disclosure rule for US companies. Many of the comments advocated exclusion of particular groups of employees from the ratio calculation. In response the SEC's Division of Economic and Risk Analysis (SEC-DERA) published analysis on June 4, 2015. The purpose of the analysis was described as follows:

"The staff believes that the analysis will be informative for evaluating the potential effects on the accuracy of the pay ratio calculation of excluding different percentages of certain categories of employees, such as employees in foreign countries, part-time, seasonal, or temporary employees as suggested by commenters."

The rule which was finally adopted by the SEC provides some flexibility to companies in calculating their pay ratio. This includes the flexibility to exclude non-US employees, but only in circumstances where data privacy laws or other regulations in the country of employment conflict with the ratio disclosure rule. Exclusion of part-time, temporary or seasonal workers is not allowed. As can be seen from the following graphs, the assumptions and choice of threshold to exclude matters. Under a scenario in which 20% of the below median pay workforce are excluded the ratio decreases by 13%.

2.4 Full-time equivalents (FTE)

Regardless of whether average or median is taken as the basis for pay comparison, or whether some employees are excluded, a decision must also be made about how to quantify the measure for employees used in the calculation.

In the UK listed companies must disclose the average number of employees in the financial year being reported on. The average number of employees required by s411 of the Companies Act 2006 subsection (1)(a) or (b) is determined by dividing the relevant annual number by the number of months in the financial year. What the Act refers to as "the relevant annual number" is determined by counting the number of persons employed under contracts of service by the company in that month (whether throughout the month or not).

Some companies also disclose an employee figure using a measure of Full Time Equivalents (FTE). Unlike the mandatory average employee disclosure FTE is not required or defined by the 2006 Companies Act. Amongst FTSE 100 companies 11% disclose a measure described as FTE, although in many cases the measure is not well defined. It is likely that the hours worked or contracted by part time workers is aggregated and expressed as a full time equivalent. Within this group several companies simply fail to disclose the legally prescribed average employee measure. The impact on ratio disclosure can be seen from the data provided by companies that helpfully provide both an FTE and average measure. For example BSkyB's single figure *table 05* **SEC-DERA exclusion analysis**

Potential effects on the pay ratio of the exclusion of various percentages of employees under alternative scenarios and assumptions

Standard deviation (stigma)		**0.25**		**0.35**		**0.45**		**0.55**
Scenario	**Ex below median**	**Ex Above median**	**Ex below median**	**Ex Above median**	**Ex below median**	**Ex Above median**	**Ex below median**	**Ex Above median**
Percentage threshold								
1.00%	-0.30%	0.30%	-0.40%	0.40%	-0.60%	0.60%	-0.70%	0.70%
2.00%	-0.60%	0.60%	-0.90%	0.90%	-1.10%	1.10%	-1.40%	1.40%
3.00%	-0.90%	0.90%	-1.30%	1.30%	-1.70%	1.70%	-2.00%	2.10%
4.00%	-1.20%	1.30%	-1.70%	1.80%	-2.20%	2.30%	-2.70%	2.80%
5.00%	-1.60%	1.60%	-2.20%	2.20%	-2.80%	2.90%	-3.40%	3.50%
6.00%	-1.90%	1.90%	-2.60%	2.70%	-3.30%	3.40%	-4.10%	4.20%
7.00%	-2.20%	2.20%	-3.00%	3.10%	-3.90%	4.00%	-4.70%	5.00%
8.00%	-2.50%	2.50%	-3.50%	3.60%	-4.40%	4.60%	-5.40%	5.70%
9.00%	-2.80%	2.90%	-3.90%	4.00%	-5.00%	5.20%	-6.00%	6.40%
10.00%	-3.10%	3.20%	-4.30%	4.50%	-5.50%	5.80%	-6.70%	7.20%
11.00%	-3.40%	3.50%	-4.70%	5.00%	-6.00%	6.40%	-7.30%	7.90%
12.00%	-3.70%	3.80%	-5.10%	5.40%	-6.60%	7.00%	-8.00%	8.70%
13.00%	-4.00%	4.20%	-5.60%	5.90%	-7.10%	7.60%	-8.60%	9.40%
14.00%	-4.30%	4.50%	-6.00%	6.40%	-7.60%	8.30%	-9.20%	10.20%
15.00%	-4.60%	4.80%	-6.40%	6.80%	-8.20%	8.90%	-9.90%	11.00%
16.00%	-4.90%	5.20%	-6.80%	7.30%	-8.70%	9.50%	-10.50%	11.70%
17.00%	-5.20%	5.50%	-7.20%	7.80%	-9.20%	10.10%	-11.10%	12.50%
18.00%	-5.50%	5.90%	-7.70%	8.30%	-9.70%	10.80%	-11.80%	13.30%
19.00%	-5.80%	6.20%	-8.10%	8.80%	-10.30%	11.40%	-12.40%	14.10%
20.00%	-6.10%	6.50%	-8.50%	9.30%	-10.80%	12.10%	-13.00%	15.00%

Source: SEC-DERA Exclusion analysis June 2015

table 06 **Components of Nil Cost UK pay ratio**

CEO single figure ÷ {
Part 3 s4 Large & Medium Sized Companies & Groups (Accounts & Reports) (Amendment) Regulations 2013

Aggregate amounts in wages and salaries paid or payable, social security costs and other pension costs incurred by the company in respect of that year
s411 CA 2006

―――――

The number of persons employed under contracts of service by the company in that month (whether throughout the month or not) divided by number of months in the financial year
s411 CA 2006

} = **Nil Cost Pay Ratio Disclosure for UK Incorporated Listed Companies**

ratio narrows from 145 to 121 on a FTE measure. Barclays' single figure ratio narrows from 152 to 145. FTE may be based on a measure of the number of hours contracted to be worked by people employed. It is also possible to calculate and disclose a FTE figure based on the number of hours worked rather than the number of hours contracted to be worked. Where companies use contracts of service which do not stipulate a minimum number of hours to be worked (zero hours contracts) such employees should properly be regarded as employees for the purpose of s411 disclosure. However, in a situation where a zero hours employee was not required to work in a given month the FTE figure for that month would not recognise the fact that the company had a contracted employee.

In the US the new pay ratio disclosure rules explicitly prohibit FTE adjustments for part-time employees, whereas the EU CRD IV disclosure rules explicitly require disclosure on a FTE basis, and as stated above UK law requires disclosure of average employees based on total headcount. A UK listed company which is incorporated in the UK and falls into the CRD IV financial institution definition but also does business in the US and fails to meet the foreign private issuer definition under US federal law[6] is now subject to three different but mandatory methods of reporting employee numbers. Hours worked compared to number of people employed clearly makes a significant difference to a pay ratio.

The Companies Act also requires disclosure of the aggregate amounts in wages and salaries paid or payable, social security costs and other pension costs incurred by the company in respect of that year to the people included in the "relevant annual number".

[6] 17 CFR 240.3b-4(c).

The mandatory disclosure of average number of employees and employee costs should allow for a simple and straightforward calculation to produce the average employee element of a CEO to average employee pay ratio. When this number is divided into the CEO single figure (a figure for which the calculation is already prescribed by statutory regulations) a simple pay ratio is produced. **No additional costs need be incurred by UK companies to produce this figure.**

Definitions of pay

Employers adopting a pay ratio will need to consider which definition of earnings is most appropriate for their organisation. Employers are already subject to rules which require them to define earnings in different ways for different purposes. For example, qualifying earnings for the purposes of pension auto-enrolment includes bonus and overtime, whereas many existing pension scheme rules do not include these items in their definition of pensionable pay.

Cost to the company or benefit to the individual

At the top end of a CEO to employee ratio the question of whether the figure used to represent CEO pay is the cost to the company or the benefit to the individual is most pertinent to share based incentive award valuations. For employees, it is more typical for pay to comprise only fixed pay and possibly a cash bonus. The principle difference between pay expressed as a cost to the company and as a benefit to the employee is tax. For most employees personal tax liabilities arising from income received from an employer are borne by the individual employee, and as a company has no control over the rate of tax paid by its employees it makes sense for any pay ratio to focus on amounts paid to the employee rather than the post tax value of those payments.

However, where pay arrangements are more complex and for example include share awards the design of CEO remuneration can engineer a reduction in personal tax liability. The differential between Capital Gains Tax (CGT) and the top rate of income tax acts as a significant incentive to take remuneration in the form of shares. This is also observable in retirement provision. Pension is an attractive way of receiving remuneration because the tax relief increases as the income increases. A ratio based on benefit to the individual would reflect differing levels of access to forms of remuneration which have tax advantages. A ratio based on cost to the company does not. ■

3. Elements of pay

Salary – it is clear that cash salary presents the least obstacles for valuation and transparent reporting. A measure based purely on salary, however, would result in meaningless disclosure at companies where the CEO's pay is comprised almost exclusively of bonus. For example at Sports Direct CEO Dave Forsey's 2015 bonus represented 98% of his total pay for the year whilst salary represented just 2%.

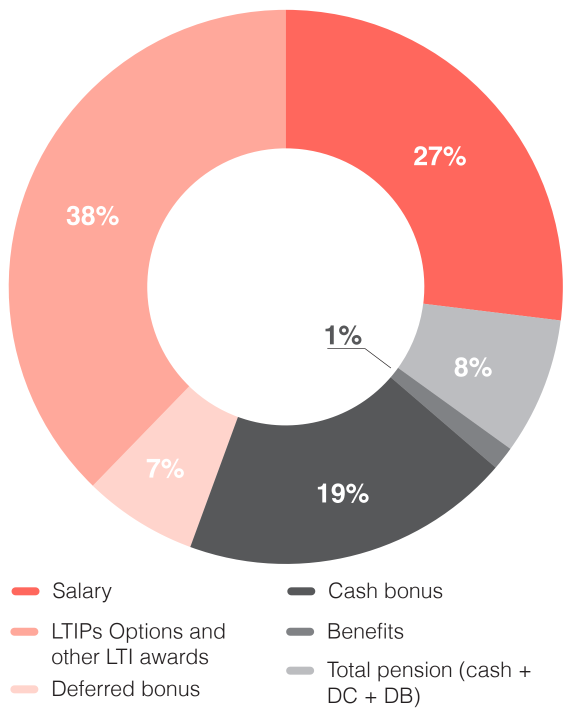
Bonus (not deferred) – it used to be the case that the value of bonus to the individual could easily be expressed as a percentage of salary as it was paid in cash at the end of the financial period to which the performance being measured related. This is no longer the case. Most companies now award "deferred bonus" in the form of shares, and valuation of this element of pay is therefore subject to the same difficulties as so called long term incentive plan awards or share options which pay out following multi-year performance periods.

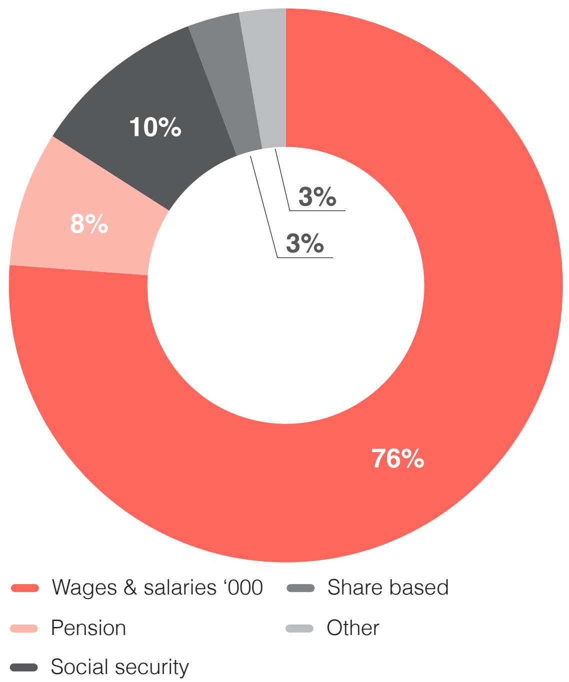
Deferred Bonus – the vesting period to which a bonus is subject determines the minimum period a recipient must wait before payment. The vesting period may be different to the period over which the performance to which the bonus relates is measured. Vesting or deferral periods have traditionally been associated with long term incentive schemes, but the distinction between annual bonus and LTIP is becoming blurred as bonus is increasingly deferred. Longer deferral is now required for finance sector executives subject to the PRA and FCA remuneration codes[7], and for some senior staff seven years is now the minimum. The fact that an individual must wait for payment changes the value of the award. The time value of money is a universally accepted concept in valuing the present value of a future gain. Discounting is also used in practice by executives in negotiating bonus levels where bonus is deferred. A key finding of a 2010 study conducted by audit and accounting firm PWC into the psychology of incentives[8] was that executives value deferred pay significantly below its economic or accounting value – a deferred bonus is typically discounted by around 50% over three years.

Multi-year/Long Term awards – share based pay now accounts for around 45% of the typical CEO's pay and around 3% of

7 Strengthening the Alignment of Risk and Reward: new remuneration rules PRA PS 12/15, FCAPS 15/16
8 http://www.pwc.co.uk/services/human-resource-services/insights/making-executive-pay-work.html

figure 04a and 04b **FTSE 100 CEO & Employee Pay Breakdown**





Source: Manifest

aggregate FTSE 100 employees pay. The value of such awards as captured by the single figure accounts for most of the difference in the quantum of pay between CEOs and average employees.

Despite the fact that variable pay already accounts for more of the CEO/employee pay gap than fixed pay the awarded value (or the single figure value) is likely to underestimate the value which such awards will eventually pay out to the CEO. For multi-year awards the single figure value is the realisable amount from awards that vest in the year under review, however the value to the individual is the number of shares multiplied by share price at the date the shares are sold, and not the date from which they vest. Any subsequent growth in share price is not reflected in the reported value. For the awarded value share awards are based on an estimate of expected value and it is also possible that these estimates under- or overvalue the eventual gain made by a director, which may crystallise many years after the award or vesting date.

Benefits

Employee benefits account for about 10% of total employee compensation at FTSE 100 companies, although estimates vary and some estimates put benefits at closer to 30% of total employee pay.[9] As with variable share based pay and pension benefit, payments can amplify the pay gap by including tax advantaged items which are not typically available throughout the organisation.

A trawl through FTSE 100 executive director benefits reported for the most recent financial year reveals that payments intended to offset higher tax charges to the individual are common. Boards often act to "protect" highly paid executives from personal taxation. It should be noted that as benefits these payments then become taxable. FTSE 100 executive director benefits included:

Personal tax and tax preparation advice; cash to compensate for having to pay tax on pension contributions; cash allowance on tax charges in respect of accommodation; tax equalisation payments; overseas salary or payroll taxes, tax gross up; federal income tax associated with conversion of a company; tax return preparation costs and protection against difference between UK and overseas employee social security obligations.

The nature of other benefits that were provided in 2014/15 to UK large cap executives reads increasingly like a list of outrageous rock star back stage "riders". Van Halen famously requested bowls of M&Ms but with the brown ones taken out. Whilst there was no evidence of M&Ms, the list did include:

London club membership; home to work travel; chauffeur; telephone costs; car parking; spouse business related travel; home security; fees for children's schooling; cost of living adjustment; home trip allowance; private petrol allowance; exchange rate protection; tax gross up; compensation for the absence of any award made under the option scheme; legal advice; retirement gifts; attendance at retirement functions; disturbance allowance; telecommunications and computer equipment; income protection; attendance at company award ceremonies and attendance at sports events.

Whilst these benefits were not provided exclusively to CEOs they are far more prevalent amongst CEOs than across the wider workforce, and therefore tend to widen the pay ratio for this reason.

2.4.3.7 Pension

There are clear differences between retirement provision at director level and pension

[9] Zurich Insurance Group estimate https://zurich.com/en/campaigns/captive-consolidation/expertise?WT.mc_id=z_gc_b2b_ba_4250369_8689057_1608047_119505198_62723745

provision throughout the rest of the workforce. For example, the all employee figure has in the past been likely to include some employees who are disqualified from joining the company pension scheme due to typical time-served eligibility criteria. Employers now have a legal duty to enrol staff who are eligible into a workplace scheme and contribute towards it.

There are three main approaches to pension provision at board level – occupational defined benefit schemes (DB), occupational defined contribution schemes (DC also known as money purchase), and personal cash allowances in lieu of pension. It is also possible for directors to participate in workplace pension schemes, however these schemes are typically personal pension schemes or stakeholder pension schemes which employers use for auto-enrolment.[10]

For payments in lieu of pension and defined contribution schemes the valuation is straightforward. For the purposes of the 2013 pay regulations, which introduced the single figure, companies must disclose the cash value for payments in lieu of pension and the cash value of company contributions to a DC scheme. For DB pension valuation is more problematic. For a ratio which expresses CEO pay as a multiple of employee pay, the existence of DB benefits is an important element. Defined benefit arrangements are generally held to be the most attractive form of pension, but companies have moved away from such schemes due to increased liabilities. This move away from DB has shifted investment risk from the corporate sector to the individual, and **the relative risks faced by a CEO participating in a DB scheme and employees participating in a DC scheme (or vice-versa) will not be reflected in a pay ratio.**

The issues around an appropriate measure for reporting pension at board level were rehearsed during the process undertaken to produce the single figure, which eventually became part of required reporting under the new UK pay regulations introduced in November 2013. The Financial Reporting Council's Financial Reporting Lab consulted on appropriate measures for each element of the single figure including pension in June 2012. Pension proved to be one of the most difficult areas to resolve.

"While a measurement basis was obvious for most of the components within the single figure, it was not so obvious for others. At the suggestion of the investors, companies came together to develop proposals as to how to resolve the practical measurement issues related to measurement of combined funded and unfunded defined contribution and defined benefit pension plans."

[10] Every employer with at least one member of staff now has a new legal duty to enrol those staff who are eligible into a workplace pension scheme and contribute towards it.

table 07 Reduced DB risks that don't show up in a pay ratio

Insolvency Risk	Depends on the regulatory regime in the market in which the scheme is offered. Listed companies with DB schemes often have multiple DB arrangements. Insolvency risk is typically mitigated through the creation of a pension benefit guarantee agency – such as the Pension Protection Fund in the UK which assumes responsibility for a portion of the promised pension in the event of a sponsoring companies bankruptcy.
Inflation risk	Benefit payments may or may not increase in line with any post retirement increase in the general price level. The plan rules will dictate is a participant bears inflation risk.
Accrual risk	Risk arises because the value of benefits under a DB scheme does not accrue in a linear fashion and much of the value accrues in the final years before retirement. The value of a DB scheme is very sensitive to any changes that happen in these final years whther these are negative such as loss of employment or positive such as additional artificial credited years of service. Accrual risk is mitigated when a DB participants entitlements are bought out on recruitment by a new employer. There are several recently disclosed examples of this happening with regard to director appointments at UK listed companies.

While different preferences for measurement of variable pay were resolved through a number of meetings, calls and emails, the FRC Lab consultation paper acknowledges that agreeing a measurement basis for pensions proved to be more difficult. The first issue to determine when considering the value of pension as an input to a ratio figure is whether the contributing value should be the cost to the company of providing any increase in pension benefit or the value to the individual of the benefit provided. Different methods of measuring value are used depending on this choice.

The three different methodologies debated by the FRC Lab participants were;

- **IAS19** – likely to result in the highest value in current market conditions – set by the directors on a 'best estimate' basis of the cost to the company; discount rate is not set by the directors and is based on corporate bond yields; the basis is subject to audit. The IAS19 and transfer value bases take into account the individual benefits provided by the plan in which the executive director is a member.
- **Transfer value** – likely to be a middle figure – set by the trustees on a 'best estimate' basis of the benefit to the individual; trustees set the discount rate, which should reflect the scheme's investment strategy; so is likely to vary more for each company. Method is currently commonly used.
- **HMRC methodology** – likely to result in the lowest number – multiplies the increase in the pension benefit by 16 or 20 to estimate the benefit to the individual.

In the end the investors participating in the consultation came together and agreed the following preferred measurement basis for defined benefit pensions: 20 times the increase in estimated pension benefit for the current year.[11]

2.4.3.8 National insurance (NI)

Employers National Insurance costs are not included in the CEO single figure, however National Insurance costs fall under social security costs which must be reported by companies. This difference introduces an obvious distortion to a simple pay ratio that compares the CEO's reported single figure with total staff costs. However, social security costs are separately identified within s411 disclosures and can be adjusted for, although a company choosing to disclose a ratio on this basis would be expected to provide an explanatory note to this effect.

[11] https://frc.org.uk/getattachment/3a986e-fa-82e5-4f08-b70c-a2f-fc22dedc5/FRC-Lab-A-single: Appendix 2 Measurement Issues

4. One size fits all versus sector

There is a trade-off to be made between the utility of a ratio and the ease and simplicity with which it may be introduced.

In the UK we have the advantage of having a listed company sector which is subject to relatively uniform legal reporting requirements. As shown above, the CA 2006 s411 disclosures allow for a quick and easy solution to ratio reporting. In the US there is potentially a far greater variety of legal prescription due to differences between state law in each of the states in which companies may incorporate.

Cost is not a credible obstacle to ratio disclosure in the UK given that data is already required to be collected. The principle weakness of a one size fits all approach is the degree of variance in CEO to average ratio due to the nature of the business being undertaken.

For listed companies (including AIM) with a financial year-end 31st December 2014 the CEO Awarded to average employee pay ratio ranges from 1.7 at Miton Group plc an investment management business with just 49 employees to 929 at Carnival plc the cruise operator with 91300 employees.

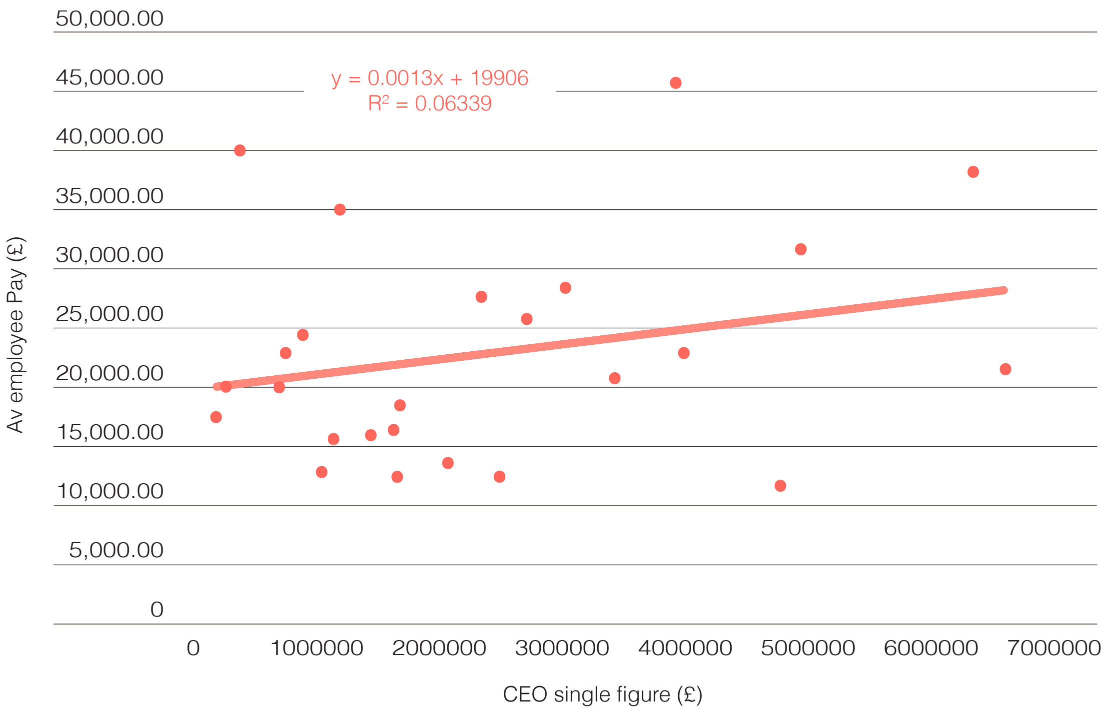
Different ratios but very different businesses. To adjust for this obvious mismatch in business models we considered if sector could act as a proxy for businesses of a similar nature and make intra company comparison more meaningful.

Income distribution in the retail sector in particular has been the focus of much recent media attention. Prior to the chancellor's announcement of the new national minimum (aka "living") wage, campaigning for the UK Living Wage, a minimum wage level above the official rate and set annually by the Living Wage Foundation,[12] focused on UK listed retail companies. Supermarkets in particular will be affected by the introduction of the new national minimum wage as they employ relatively large numbers of lower paid workers.

The fact that the points are not particularly close to the trend line suggests there is nothing particularly consistent about the relationship between levels of employee pay and levels of CEO pay within the retail sector.

[12] http://www.living-wage.org.uk/

figure 05 **Correlation of retail sector pay ratios to CEO pay**



Source: Manifest/MMK/High Pay Centre

The lack of a consistent relationship between average employee pay and CEO pay for companies in the same sector (in this case retail) suggests that sector may not be the answer to lack of comparability.

Lack of adequate human capital reporting is a key factor limiting comparability of company pay ratios.

No two companies are the same. In essence a pay ratio forms just one part of a range of information which companies are able to make available with regard to their human capital. Such information does not fit easily into the models used by portfolio managers to assess comparative risks. Listed companies are economically important in the UK. They employ around 6 million people. However, these companies are also economically important in their own right. Understanding the differences between businesses in the same sector properly means looking at every aspect of a business, including its workforce. Company by company analysis may reveal why a steel business in south Wales is more resilient to the same macro economic problems than a similar business in Redcar.

Ratios become more meaningful when accompanied by human capital disclosures, which support a more fundamental analysis of the role played by income distribution in motivating and rewarding the people whose efforts companies rely on to deliver the returns which investors expect.

5. The case for ratios

5.1 Productivity

It is clear mechanisms exist which can act as a link between pay and productivity. Money distributed to executives as incentive payment could of course have been retained for investment, for example in technological advances which could fuel productivity. In some cases this choice makes a material impact on financial statements, for example the incentive scheme at Berkeley's Homes has the potential to deliver 13% of Berkeley's equity to the directors.

In most cases, however, this is not so. Executive pay as a whole is unlikely to be at a level above the materiality threshold set by each UK listed company's auditor for the purposes of auditing the financial statements (see analysis of materiality threshold/executive pay quantum below). Executive pay disclosures in a remuneration report must be subject to audit regardless of this threshold. The quantum of executive pay is therefore unlikely to have a direct significant impact on any investment using retained earnings which aims to fuel productivity.

The mechanism which links executive pay and share repurchases at listed companies is likely of greater significance. The High Pay Centre's recent study of performance metrics[13] found that 100% of companies in the sample used earnings per share as a performance metric for their short term incentive schemes. The number of shares in issue reduces when directors exercise their authority to buy back shares using shareholder funds. This has the effect of increasing earnings per share, and where no discretion is used to adjust incentive awards for this effect can act as a trigger for bonus payments.

Other metrics commonly used for executive incentive schemes are also sensitive to a reduction in outstanding shares.

Unlike executive pay the quantum of shareholder funds being used for share repurchase is material. Interviewed in June 2015 Andy Haldane, the Bank of England's Chief Economist, described companies as "eating themselves" when he characterised the behaviour of companies in returning increasing amounts to shareholders. Haldane quotes figures that show total payouts to shareholders from both dividend and buy-back totalling £100 billion in the UK in 2014[14] This contrasts with the amounts that are being invested in training. A lack of well trained staff is cited by the government in its recent productivity paper as a factor which has contributed to stagnant productivity levels:

> *"the UK suffers from several weaknesses in its skills base that have contributed to its longstanding productivity gap"[15]*

Although the quantum of executive pay is unlikely to have a direct impact on productivity in most cases the structure of executive pay is likely to be more influential. So too will changes in overall staff costs. The extent to which pay differentials between any group within an organisation are linked to performance of the group is critical to solving what has been called "The Productivity Puzzle"[16] Evidence from the High Pay Centre's own study suggests that where ratios are too wide

[13] http://highpay-centre.org/pubs/the-metrics-re-loaded-examining-executive-remuneration-performance-measures

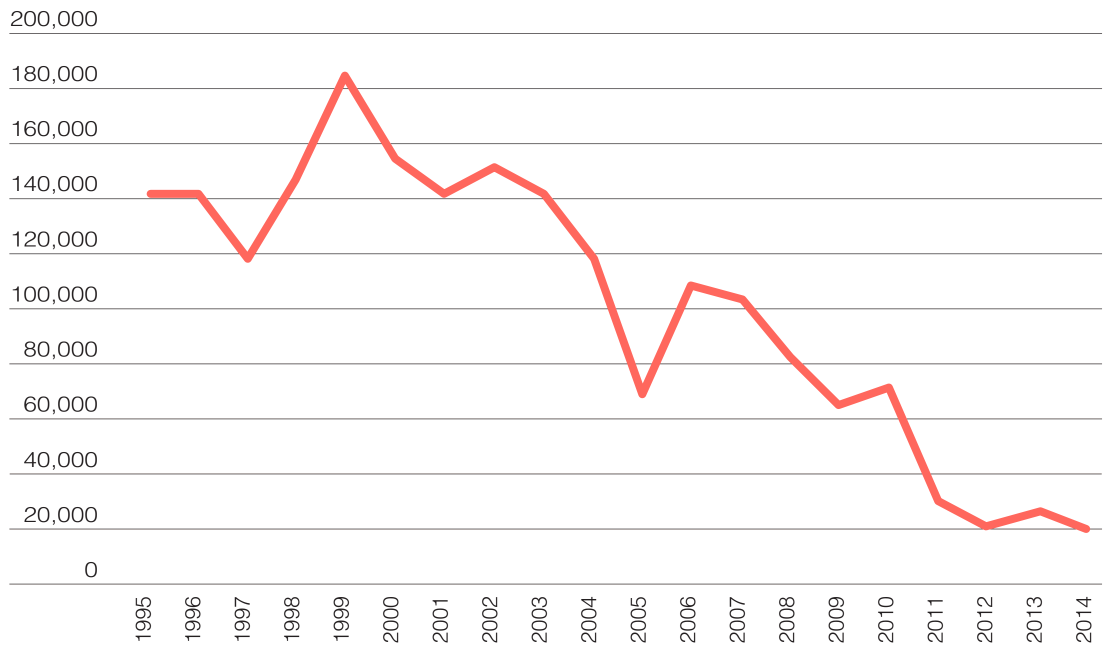
[14] http://www.bankofengland.co.uk/publications/Pages/speeches/2015/833.aspx

[15] Productivity Plan 3.1 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/443898/Productivity_Plan_web.pdf

[16] The productivity Puzzle.....NIES

figure 06 Training away from workplace trend 1995-2014

Number of employees who worked fewer hours than usual in reference week because they attended a training course away from their own workplace



Source: ONS. Labour Force Survey Variable YLE SS6 performance suffers.[17] Anecdotal evidence also suggests that where differentials are too low this impedes career progression, for example, the loss of tax credits due to higher income may act as a disincentive to accept promotion. The trade-off between greater responsibility with potential for longer hours and a marginal increase in income may not be sufficiently attractive.

Social science research conducted on behalf of the government also points to a link between pay and productivity. Fairness is one of the elements which drives employee wellbeing (job satisfaction). In research conducted by the NIESR on behalf of the UK government[18] higher pay (not unexpectedly) is identified as one of the elements that contribute to wellbeing at work. The study goes on to say that:

“this relationship depends not only on the absolute level of pay but how this compares with pay of other workers”

The academic work cited by the October 2014 BIS study[19] points to an important comparative element to the relationship between pay and job satisfaction, with workers typically more satisfied if they are paid more highly than their comparators. The BIS study also finds that workers’ pay satisfaction is higher the more their co-workers earn and the better their own position in the wage distribution within the workplace.

The corollary to this is of course that employees who are relatively poorly placed within a company’s income distribution have less job satisfaction.

Statistical analysis conducted using the 2011 Workplace Employment Relations Study showed “a clear, positive and statistically significant relationship between the average level of job satisfaction at the workplace and workplace performance.” Critically the report goes on to say that:

“Employee job satisfaction was found to be positively associated with workplace financial performance, labour productivity and the quality of output and service”

5.2 Good reason for pay gaps

Proponents of tournament theory[20] hold that fixed pay gaps act as an incentive.

“the large salaries of executives may provide incentives for all individuals in the firm who, with hard labour, may win one of the coveted top positions”

However, as an efficient method of allocating resources (shareholder funds spent on staff costs) incentive reward schemes are considered as an alternative to fixed pay gaps rather than as a supplement.

An examination of pay differentials between CEOs and other executive directors reveals that the incentive effect suggested above should be present at nearly all listed companies. The MMK-Manifest Remuneration survey found that where the CEO is the highest paid director the salary of the second highest paid director is typically 66% of CEO salary.[21] In this scenario higher levels of share based incentive awards for CEOs potentially act as an additional layer of incentive even where incentive can be assumed to already exist.

A key assertion in the academic work which put forward the theory was that in situations where earnings are decided by rank it is the difference not the distance that matters. For CEOs and other executives salary levels already represent this difference. Higher levels of share based awards to CEOs serve to amplify the difference.

The High Pay Centre’s own work[22] confirmed that pay differentials can be seen to act as an incentive. However, it also identified negative consequences where these differences grow too large.

If pay differentials are to be justified by reference to their motivational effect **the differences must be known in order to draw any conclusions**. Measurement of and disclosure of these gaps in the form of pay ratios provides a tool for management to establish the differentials which can be seen to work for their business model.

5.3 Team effort

Even without reference to motivational effects there are good reasons for pay gaps. The most easily defensible of these is that the person whose pay represents the numerator in calculating a pay ratio is personally and explicitly responsible for generating the value in a business through their creativity and inventiveness.

Listed companies now routinely assert loss of key personnel as a principal risk – on this basis high pay becomes a risk mitigation tool for the business, and as such becomes unassailable.
In this scenario any attempt to curb high pay is interpreted as a weakening of the company’s ability to mitigate its risks. The identity of

[17] http://highpay-centre.org/pubs/the-high-cost-of-high-pay-unequal-work-places-suffer-more-strikes-and-higher
[18] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/366637/bis-14-1120-does-worker-wellbeing-affect-workplace-performance-final.pdf
[19] (Green, 2006; Brown et al., 2008). Bryson et al (2012)
[20] http://faculty.smu.edu/Millimet/classes/eco7321/papers/lazear%20rosen%201981.pdf

[21] Relates to listed companies with market cap greater than £m 10,001
[22] Ibid

the individuals to whom this risk attaches is never disclosed.

A significant minority of FTSE 100 companies - 30% - do not regard loss of key personnel as a principal risk. It is reasonable to assume that these companies do not regard executives as possessing unique and irreplaceable skills! Average CEO pay at these companies is lower than that at the companies where loss of personnel is identified as a risk (GBP 4.8m compared to GBP 5.2m), which is consistent with the use of pay to mitigate risk.

14% of the FTSE 100 companies that recognise loss of key personnel as a risk describe the risk purely in terms of a competitive market for executive talent rather than referencing a hard to replace skill set (still less describing irreplaceable values) which a departing executive would take with them.

Significant shareholder dissent with regard to directors' pay has been evident at companies where the CEO is identified as contributing significant value by virtue of their exceptional skill or creativity. Burberry and WPP both registered large opposition votes in recent months, and both claim to have CEOs whose departure would adversely affect the value of the business.

Concentrating the value in a business to the extent that value is overly sensitive to the assumed departure of a single individual is inconsistent with public listed company status. The continued tolerance of wide pay gaps on the grounds of irreplaceability risks inviting questions about why such companies remain in the listed sector.

5.4 Bonus waiving – pay is off the spectrum

The waiving of bonuses has become a modern form of noblesse oblige. Over the last couple of years a succession of CEOs at UK listed companies have handed back or refused to accept money that was due to them. Examples include: Ivan Glasenberg at Glencore; Stephen Harris at Bodycote; Ian Marchant at SSE; Mark Allan at Unite Group; Justin Atkinson at Keller Group; Jeremy Helsby at Savills; Terry Sweeney at RM; Peter Sands at Standard Chartered; Dalton Phillips at Morrisons; Antony Jenkins at Barclays; Lord Wolfson at Next; Tom Albanese at Rio Tinto; Mark Carne at Network Rail; Stephen Hester at RBS; and Philip Clarke at Tesco.

Bonus waiving appears to be gathering pace. In the 12 years between 1995 and 2007 we identified 16 companies where a CEO had waived bonus. This compares to 15 companies in the 6 years from 2008 to 2014. While public bonus refusal reflects well on the individuals concerned it also reflects poorly on the pay systems that produce surplus remuneration for those at the top. It is notable that several of the refuseniks subsequently left the board and that the year of bonus waiving coincided with poor year-end financial results. In such cases it appears CEOs are being allowed to renounce a bonus which was never going to be paid, and the impression is maintained that the CEO has a role in deciding on his own remuneration.

Bonus refusal gives out two distinct messages. The first is that the CEO recognises the unique privilege which comes with payments that are unconstrained by any of the normal mechanisms that determine pay for other employees. The second is that the remuneration committee has got it wrong.

Nothing says financial security like refusing to accept a bonus. In contrast, the income received by an employee in the same business on a zero hours contract is not even recognised as income by many mortgage lenders, regardless of the amounts shown on payslips and P60s.

Bonus waiving is a clear signal that pay and conditions for highly paid employees in a company have become detached from those applicable to most employees. The publication of a pay ratio recognises that all employees who rely on the same organisation for their income should at least have pay and conditions that belong on the same spectrum.

5.5 No Constraints

In light of the fact that pay elsewhere in the organisation does not appear to be acting as a constraint on levels of executive pay, it is worth taking a closer look at the factors which can be assumed to constrain executive pay.

5.5.1 Affordability

Pay is a tangible cost of doing business: an overhead. However, pay at the top of listed company income distribution forms a relatively small part of this overhead. Only one company in the FTSE 100 discloses executive pay which is higher than the threshold for materiality set by its auditors for the purpose of the audit of annual group accounts. In fact executive pay could be doubled at 80% of FTSE 100 companies and would still not be a material amount for the purposes of the accounts. Reliance on affordability with regard to executive pay misses the point – it will generally always be affordable.

5.5.2 Legal

The new UK pay regulations introduced a requirement for companies to disclose the maximum amount payable to each individual director under the remuneration policy being proposed for shareholder approval.

For each of the components described in the future policy table the company is required to disclose:

"the maximum that may be paid in respect of that component (which may be expressed in monetary terms, or otherwise)" Large & Medium Sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 Para 26 (c)

Few companies quantify this upper limit in monetary terms or otherwise. The government's own review of responses to the 2013 remuneration regulations found there was:

> *"a significant level of non-compliance with the requirement to specify clearly, in monetary terms or otherwise, the maximum future salary that may be paid under the remuneration policy"*

In fact 93% of the sample companies looked at by BIS failed to state a maximum. The absence of a quantified limit effectively nullifies the impact of personal legal liability which attaches to directors in the event that they sanction a payment which is outside the terms of the approved policy. Since the imposition of a legally prescribed minimum wage there has been a legal remedy in the event that companies pay too little. The lack of quantified and disclosed maxima continues to ensure there is no equivalent legal remedy against paying too much.

This is not true of all legal jurisdictions. For example, Indian Company Law (section 200 CA 2013) now provides government with the power to fix management remuneration in cases where the company has inadequate or no profits.

5.5.3 Market forces

Executive pay is insulated from normal market forces. The practice of external benchmarking (comparing executive pay levels to those at other companies) is widespread amongst listed companies, but is an artificial reflection of supply and demand for executive pay. External benchmarking is a poor measure of the significant value which individuals place on things like proximity to family and cultural fit. The value of external benchmarking rests on the false assumption that all companies included in the comparator group are a threat to the retention of existing executives, and that "executive competencies" are wholly transferable.

In fact listed companies are more likely to hire a CEO from amongst their own executives as they are from a peer company. For the purposes of this report we looked at all CEO appointments for UK listed companies in the last couple of years (January 2013 – October 2015). (Direct appointments to the role of CEO were isolated from initial non-executive appointments, which were subsequently followed by CEO appointment in the same year. Appointments of a founding director to the role of CEO were also excluded as were appointments to the CEO role in a temporary capacity.)

Out of 207 CEO appointments 46% were external and 54% internal.

The fact that a competitive marketplace for the CEO position exists inside a company gives credence to the idea that using an external comparator during the process of setting executive pay levels, particularly using the unrealised pay of a targeted candidate, gives a distorted reflection of the demand which determines a CEO's pay level.

Under normal market forces there would be a market for a potential candidacy. However, such a market can only develop once a role has been advertised together with the going rate for the job. This process is bypassed when a headhunter is used to recruit. In such a model the headhunter is attracted to the candidate rather than a pool of candidates being attracted to a position. The target candidate for the headhunter is asked about the terms under which they might find the position attractive, This process invites self worth estimates in a context where the approached candidates current pay may be the only known parameter. The headhunter has a vested interest in generating a high price given that commission depends on the price paid. Overpayment is the inevitable result. Without an open competition executive pay remains insulated from the effects of any demand that might act to lower the price paid for an executives services.

The wide differences between CEO pay across indices and within sectors suggest pay at CEO level now has little to do with the job of being CEO. The principle alternative to market-based pay is to base pay on a job evaluation system in which jobs within an organisation are ranked according to their value to the organisation. Such top to bottom job evaluation systems were popularised in the 1950s following the introduction of the Hays system. However, what was once accepted as best practice has been largely replaced by the dominance of market-based pay at executive level.

The adoption of a pay ratio automatically integrates pay at the top of listed companies into an organisation's formal pay scale. The loss of accepted best practice has coincided with the period in which executive pay awards have accelerated.

Adoption of a ratio is an automatic re-integration of top roles into the group.

5.5.4 Embarrassment

Senator Gallagher, one of the two SEC Commissioners to vote against introduction of a proposed ratio disclosure rule in the US, has cited a quote by Brandon Rees, deputy director of AFL CIO, as evidence that proponents of pay ratio disclosure have a hidden agenda: to name and shame public company CEOs. Rees had stated that CEOs "will be embarrassed" and "that's the whole point". Gallagher is half right – the naming of CEOs whose pay is many hundred times greater than the pay of employees in the same organisation is made possible by ratio disclosure – the shaming, however, is not.

As Lord (John) Monks, the former general secretary of the TUC, has asked: "How do you shame people who are shameless?"

The fact is that how much a person is paid is still considered to be private and therefore a sensitive and emotive subject. Informal cultural unease about discussing pay is reinforced by more formal barriers. The recent UK government consultation on the gender pay gap (GPG)[23] surveyed employers regarding their ability to report on pay differentials, and identified that some staff are contractually bound not to discuss their pay with colleagues. Not all markets share the same cultural resistance to pay disclosure. In Norway you can obtain information on anybody's income and taxes paid through public records available online.

Privacy has for many years been used by employers to discriminate between employees in line with their perceived value to the business. Undisclosed different pay levels still perform this function.

A government consultation on closing the gender pay gap (GPG) ended on September 6th 2015. Disclosure of pay differentials is at the heart of the proposed solution. The case for increased transparency is set out in the government's impact assessment which accompanied the launch of the consultation:

> *"Some employers are not aware that they have a GPG. Transparency can provide employers with greater insight into progress, driving a greater focus on analysis particularly in light of the board level interest that publication of information can generate, thereby prompting changes to, or reviews of, their working practices and policies, catering more to the needs of employees."*

Although there is more to do, and the gender pay gap is closing far too slowly, women are increasingly being paid at the same rate as men. The government's consultation paper claims the gender pay gap has been virtually eliminated for full-time workers under 40. This progress owes much to the 1970 Equal Pay Act. However, the strike which in part gave rise to that act would arguably never have occurred without a formal pay grading structure under which a going rate for the job was made clear. The attempt to regrade the job of sewing car seat covers would have had less of a reaction had the relative pay for jobs of different grades been opaque. Some of the opposition to pay ratios obscures a fear amongst employers of having to justify pay differentials between those at the top of a company and the rest of the workforce by reference to objective criteria.

5.6 Gender ratio and pay ratio. Human Capital matters

The stated aim of the new pay ratio disclosure rule in the US is to inform shareholders voting decisions.

We believe that the pay-versus-performance disclosure mandated by Section 953(a), and the disclosure of the ratio of the median annual total compensation of employees to the annual total compensation of the chief executive officer are intended to provide shareholders with information that will help them assess a registrant's executive

[23] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/450878/Gender_Pay_Gap_Consultation.pdf

compensation when they are exercising their rights to cast advisory votes on executive compensation under Exchange Act Section 14A. [SEC Release No. 34-74835; File No. S7-07-15]

Linking these ratios with a shareholder vote suggests that the lack of a ratio is preventing shareholders reflecting an opinion about pay ratios in their voting intentions. However, if the introduction of pay ratio disclosure was to have the intended effect of allowing shareholders to reflect pay ratios in their voting behaviour it would require a step change in institutional shareholder voting behaviour.

table 08 **FTSE 100 CEO (received) to average employee 2002-2014**

Year	CEO Total Remuneration Received as Multiple of Average Employee Earnings	Shareholder Voting % Dissent (Abstain + Oppose) on Remuneration
2002	69.51	16.19
2003	77.08	12.83
2004	94.16	7.38
2005	97.62	5.19
2006	98.75	6.08
2007	139.16	7.14
2008	124.32	10.06
2009	151.68	9.38
2010	132.22	9.07
2011	117.50	11.34
2012	114.35	7.55
2013	125.38	9.08
2014	149.58	8.38

Source: Manifest

As stated above, pay ratios are already calculable for UK listed companies, but are not disclosed (we also point out that on measures currently available care should be taken when interpreting their meaning). We found no evidence to date of a correlation between wide ratios as calculated from their disclosed components and shareholder voting dissent. The ratio of CEO to average employee pay at FTSE 100 companies was wider on a received basis than at any time since the shareholder vote was introduced in 2002.

Meanwhile shareholder voting dissent on remuneration report resolutions nearly halved over the same period.

So would the presence of an explicitly disclosed ratio act as a catalyst for increased shareholder dissent? To test this proposition we looked at voting by shareholders on the issue of female board membership. Gender diversity on boards has certain parallels with the pay ratio issue. Both are complex human capital issues which can be expressed in terms of a simple mathematical expression. Both are matters of public interest where regulatory solutions have been proposed that focus on public company disclosures, which might allow shareholders to influence corporate behaviour. Both are subject to arguments that are based on fairness and on economic benefit.

The Davies report placed responsibility for improving female board presence on the Chairman of the company. A target of 25% was set for FTSE 100 companies in February 2011. Despite this clear target shareholder voting dissent at companies that failed to meet the target subsequent to February 2011 showed no significant change. Since February 2011 the average dissent on Chairman's election at AGMs of companies with less than 25% female board members was 3.5% compared to 2.9% at AGMs of companies which had achieved the 25% target.

Despite the absence of gender amongst the panoply of shareholder voting concerns there has been clear progress towards the 25% female board target. The progress witnessed among FTSE 100 boards towards the Davies target has clearly not been achieved by shareholder voting.

This is not to deny the value of having a clear and simple objective, but suggests that reliance on voting by institutional investors to deliver progress on pay ratios (disclosure or adoption) is unlikely to achieve the desired results.

5.7 Corporate Purpose

The disclosure or even the adoption of a pay ratio is consistent with directors' duties as defined in UK company law. UK company law (s172 CA 2006) frames directors' duties in the context of a company's purpose, which by default is to promote the success of the company for the benefit of its members as a whole. The law does not regard this as the only possible purpose and explicitly allows for the fact that directors' duties are applicable:

> *"to the extent that the purposes of the company consist of or include purposes other than the benefit of its members"*

Directors are obliged by law to pay regard to the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly as between members of the company.

It is often remarked that shareholders should act more like owners of the companies they invest in, for example to prevent egregious executive pay settlements. However, such ownership can only be conditional ownership. A company is a legal person and to claim unmitigated ownership is to misunderstand corporate purpose. Society via the government provides companies with a social licence to operate and is entitled to act in order to impose conditions on this ownership. This has been seen recently with the imposition of a new national minimum wage. Creditors impose conditions aligned to the risks they face when companies borrow money from them. Employees also have a legitimate interest. The requirement that directors have regard to the interests of employees reflects the fact that employees face risks of their own after they have invested their human capital in the business.

In a speech to the Edinburgh Corporate Finance conference in May 2015 Andrew Haldane, chief economist at the Bank of England, made the following comments:

> *"The most straightforward way of tackling embedded stakeholder externalities is to have those stakeholders' interests weighed explicitly in the objectives and decision-making of the company. In practical terms, that would mean modifying the objectives, rights and responsibilities of a firm under Company Law. Such modifications are not, in fact, that radical either from an historical or international perspective. History clearly suggests that shareholder primacy has not always been the centrepiece of company law."*[24]

A pay ratio is public recognition of the possibility that companies serve a purpose for employees and shareholders. Just as directors must have regard to the need to act fairly as between members of the company so should they act fairly as between employees. A ratio expressing how fairly pay is shared would be one way of publicly recognising that companies should serve more than one purpose. ■

[24] http://www.bankofengland.co.uk/publications/Pages/speeches/2015/833.aspx

Conclusion

The opportunity exists for UK listed companies to produce, at zero cost, a crude but consistently measured pay ratio. This opportunity should not be ignored or delayed by reference to any regulatory process.

Companies can add value to their ratio by disclosing country-by-country data for employee costs and employee numbers. Country-by-country reporting will allow investors to judge the impact of national minimum wage and welfare regulation on a significant element of the costs borne by each business.

Boards can demonstrate they are able to align strategic priorities with human capital management by disclosing a breakdown of how the workforce is composed, including numbers of full-time, part-time, cyclical, seasonal, temporary and contracted workers. Such disclosure is complementary to a breakdown of the workforce in terms of gender.

Pay ratios offer companies the chance to demonstrate a practical commitment to consider pay elsewhere in the organisation by recognising that all employees' pay belongs on the same spectrum. ■

Design Rachel Gannon
www.inkillustration.com

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