pharmaceutical COMPLIANCE MONITOR

What You Need To Know About the CEO-Employee Salary Ratio

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With new salary reporting regulations on the horizon, financial executives throughout the pharmaceutical, biotechnology and medical device industries have a lot of work to do.

One looming issue is the recently announced Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires public companies to disclose the ratio of CEO compensation to the median compensation of the company's employees. Right now, CEO and other executive pay is made available, but no salary information is required about employees. This ratio will be included in documents such as annual reports and registration statements. This rule goes into effect January 1, 2017.

That's not a lot of time to figure out the best accounting strategy. Depending on the maturity of a company and what its particular goals are, the reporting strategies could vary widely.

Companies will have flexibility with how to define a median employee and the corresponding compensation, whether it's using salary information from every employee or a statistical sampling. Cost-of-living can also be factored in the calculation. This only has to be done every three years, and non-U.S. employees can be excluded if the country's privacy laws or regulations make it difficult to obtain the relevant data.

The new regulation is especially relevant to pharmaceutical companies, as some of the biggest CEO salaries are within the healthcare industry. Of course, average worker pay is also higher at pharmaceutical companies than in other industries such as retail, which has many lower-paid hourly workers. Another factor to consider is how commissioned sales people will affect the ratio. Typically, commissioned sales people are paid more than the average worker because their pay is tied to the commissions they receive on the sales that they make. If a company has a large commissioned sales force and its members are highly paid, this should favorably influence the CEO-employee salary ratio (meaning that the ratio would be lower). However, for companies that have little to no sales force this may adversely affect the ratio. This issue has to be grappled with by corporate leaders as they begin to comply with this new rule.

The Securities and Exchange Commission (SEC) estimates this will cost companies $73 million annually, but the U.S. Chamber of Commerce puts the number closer to $700 million. There is concern among critics that determining the ratio will result in significant compliance challenges and costs depending on the complexity of the payroll reporting mechanisms within each company. CPAs will play a major role in determining the method of calculation for each company, and will help streamline the process to keep costs down.

Basically, the SEC defines “total compensation” for a CEO. This definition generally includes items such as the salary, stock awards, option awards and bonuses, to name a few, along with other compensation such as personal benefits and perks that exceed $10,000. Also included are company contributions and defined contribution retirement plans, stock purchase discounts, any gross ups for tax purposes, life insurance premiums and dividends. Conversely, the SEC has left certain items out of the “total compensation” definition, including benefits to all employees such as group health, life and disability insurance benefits. Given the complexity of determining the above compensatory amounts in order to develop this CEO-employee salary ratio, CPAs will likely be highly involved in helping companies to determine these amounts and the ratio itself.

The gap between CEO pay and that of employees is widening every year across all industries. According to The American Federation of Labor-Congress of Industrial Organizations (AFL-CIO), the average CEO-to-worker pay ratio was 373-to-1 across all industries in 2014.

The ratio provides the context that a simple disclosure of CEO salary does not. Pharmaceutical employees will likely question why there is such a large pay disparity between the median worker and the CEO once this data is available. This may lead the pharmaceutical executives and boards to re-evaluate compensation for CEOs and employees alike. Companies with a lower ratio will likely be seen in a more favorable light.

Additionally, a lower ratio can be used as a recruiting tool to attract workers that see the respective company as more equitable and generous than the competition. It may give current employees more leverage in regards to salary negotiations as well.

Known as “say-on-pay,” The Dodd-Frank Act requires that companies provide shareholders with an advisory vote on executive compensation. The newly released ratios will undoubtedly influence many shareholders’ votes, even if it doesn’t influence public opinion as much as some predict. According to FiercePharma’s data, the top three biopharma CEOs were paid $41.97 million (Len Schleifer of Regeneron),

$36.64 million (Jeffrey Leiden of Vertex Pharmaceuticals) and $36.61 million (Brent Saunders of Allergan). CEO pay often doesn't correlate to company revenue or size. It will be telling to see if these and other companies that pay their CEOs well are as generous with their employees. Additionally, employee frustration over pay inequality is likely to become even more prevalent if the company size doesn't warrant extreme pay disparity in their minds.

AstraZeneca's Pascal Soriot and GlaxoSmithKline's Andrew Witty aren't listed in the top 20 on FiercePharma's top 20 highest-paid biopharma CEO list despite the larger size of their companies. While these numbers are important, the CEO-to-worker pay ratio will give a more comprehensive view of the company's compensation structure for investors, employees, executives and the public.

Another issue to consider is how CEO-employee pay ratios will affect investor behavior. This is an important question and one that deserves investigating. Critics of the pay ratio provision are concerned that investors will be misled when they try to compare the ratios across companies with differing work forces and levels of pay along with global companies that have international employees paid in different currencies.

From an investor perspective, the Dodd-Frank Act requires that all corporations engage in a non-binding shareholder vote on the compensation of executives in the annual proxy statements. Certain studies performed at Rice University's Jones Graduate School of Business have found that dissenting votes are more prevalent when the CEO-employee salary ratio is either at the lowest or highest levels. A dissenting vote at the highest ratio levels might put pressure on companies to reduce the ratio. A dissenting vote at the lowest ratio levels might mean that there should be a level of pay disparity to reward performance and provide incentive to workers. The studies found that there doesn't appear to be much voter dissent in the middle ratios. This may mean that investors accept what they perceive as reasonable ratios. As this act becomes mainstream, more data will be available that will provide clarity in the future as to how investors will react to this disclosure.

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Dan Price, CEO of Gravity Payments in Seattle, decided to address the CEO-Employee salary gap by increasing the salaries of all of his employees to $70,000 per year. Basically, he set the minimum wage in his company at $70,000 per year over the next three years. He also reduced his $1,000,000 pay to $70,000. There was a great deal of public support for this decision and he was considered a “thought leader” in the income inequality area.

However, this move seems to be affecting his company with customers leaving. It is true that new clients have signed up with his company, but these clients will not generate a profit for Gravity Payments for probably a year. Also, other business leaders are worried about how Price’s decision is going to affect other businesses. These business leaders are saying that they can’t survive if they do what Price did. Another argument against Price’s decision is that everyone should not be paid equally because they are not equally talented or motivated. Whichever way you lean on the subject, he has elevated the issue into the mainstream media. Time will tell whether his decision was the right one.