CEO pay ratios – should you use gender pay data to identify the quartiles?

There is ongoing debate among almost all UK plcs on whether to prepare and publish the CEO to employee pay ratio on a voluntary basis in the reports and accounts to be published in the coming months. The Investment Association, among others, has expressed its hope that companies will do this.

This is an important strategic decision for companies. A number will want to show that they are fully engaged in disclosures which centre around 'fairness' and will want to publish early; we think a (much larger) number of companies will be more cautious and will not want to publish before strictly required to do so. Of the seven FTSE 100 companies which voluntarily reported the ratio of CEO to median-employee pay in 2018, the average ratio was 72.1:1, which is significantly lower than the figures which had been predicted. This indicates that those companies which have so far chosen to report on a voluntary basis tend to be those with a lower than average ratio and, while there may well be a higher level of December 2018 companies reporting, we suspect that the bias of those reporting early will, again, be towards those with a lower ratio.

Where companies are not inclined to publish early, we expect that almost all will prepare the ratios for internal review. This will set out an internal reference point for the first publication in 2020. Indeed, we have already been helping many of our clients with performing these calculations. In this briefing, we focus on the practicalities of calculation rather than the merits (or disadvantages) of early disclosure.

Companies will be required to calculate the following figures:

The ratio of the CEO's single total figure to the total pay and benefits of the lower quartile-paid, median-paid and upper quartile-paid UK-based employee;

Total pay and benefits for the lower quartile-paid, median-paid and upper quartile-paid UK-based employee; and,

The salary component of total pay and benefits for the lower quartile-paid, median-paid and upper quartile-paid UK-based employee.

How will companies calculate the data?

The rules (The Companies (Miscellaneous Reporting) Regulations 2018) provide three methods for determining full-time equivalent total pay and benefits at each quartile.

Option A

The company must calculate the pay of benefits of all its UK employees for the relevant financial year in order to identify which employee sits at each quartile and use the pay and benefits figures for those UK employees as the three datapoints.

Option B

a) as a starting point, use the most recent hourly rate gender pay gap information for all UK employees of the company to identify three UK employees as the best equivalents of the lower quartile, median and upper quartile employees by hourly rate of pay;

b) use available data for the relevant financial year for the identified best equivalents to calculate the pay and benefits figures for each for the relevant financial year; and,

c) make any necessary adjustment to the pay and benefits figures to ensure that the best equivalents are reasonably representative of the lower quartile, median and upper quartile pay for the relevant financial year.

Option C

a) as a starting point, use data other than, or in addition to, gender pay gap information to identify three UK employees as the best equivalents of the lower quartile, median and upper quartile employees (data must not relate to a year prior to the preceding financial year and must not be less up to date than any gender pay gap information);

b) use available data for the relevant financial year for the best equivalents to calculate the pay and benefits figures for each for the relevant financial year; and,

c) make any necessary adjustment to the pay and benefit figures to ensure that the best equivalents are reasonably representative of the lower quartile, median and upper quartile pay for the relevant financial year.

Both the Investment Association and Legal & General Investment Management have stated that they will prefer companies to use Option A. Indeed, the Government's own Q&A document refers to Option A as being "the most statistically accurate" method. The GC100 has stated that investors "generally expect that Option A be adopted given it is considered the most robust, statistically."

While Option A would provide the most robust analysis, the complexity of calculating a full-time equivalent single figure number for every UK-based employee may mean that this approach will not be practical for many companies. Particular complexities are likely to arise where companies operate multiple payroll systems, where a large number of employees joined during the year and their data needs to be grossed-up or where complex, non-payroll items exist (in particular, defined benefit pensions) which vary between individuals.

Individual companies will need to find a balance between statistical robustness and practicality in this first year of calculations in order to obtain a reasonable reference point. On balance, we believe that Option B will remain the most widely used for the 2018 figures (published, if at all, in 2019), as this will enable companies to utilise the gender pay gap analysis which they are already required to undertake.

Companies should, however, be aware that there are some potentially significant, albeit technical, differences between the datasets for the CEO pay ratio disclosure compared with the gender pay gap analysis, and we highlight some potential pitfalls below. These will not impact all companies and Option B may remain the right approach for many.

Am I captured by the rules?

- The 250-employee test for the CEO pay ratio disclosure is made on a group basis whereas the test for the gender pay gap analysis is made on an employing entity basis; there will be a small number of companies which have more than 250 employees across multiple employing entities, each with fewer than 250 employees (and which, therefore, are captured by the CEO pay ratio disclosure but not the gender pay gap reporting regulations).
- It may be the case across a group that some, but not all, employing entities report on the gender pay gap and so the existing gender pay gap datasets may be incomplete for the purpose of calculating the CEO pay ratio.

Who counts as an employee?

- The CEO pay ratio disclosure falls under the Companies Act 2006 whereas the gender pay gap reporting falls under the Equality Act 2010. The term 'employee' is defined differently between the two acts, with the Equality Act using an 'extended' definition which additionally includes agency workers and some self-employed people.
- Connected to this, the Companies Act applies to the United Kingdom as a whole, whereas the Equality Act applies to Great Britain only (i.e. it excludes Northern Ireland). Companies will therefore need to include employees based in Northern Ireland for the purposes of calculating the CEO pay ratio in order to obtain robust data.
- An additional consideration relates to the inclusion of Non-Executive Directors within the

data set. The definition of "UK employee" within the DRR Regs for CEO ratios refers to a person employed under a "contract of service". The wider UK Companies Act universe would regard Non-Executive Directors as "office holders", and thus distinct from employees. Accordingly, the original gender pay gap reporting dataset may require adjustment to meet the Companies Act requirements.

What elements of pay are included?

- The gender pay gap analysis excludes a number of items of remuneration, such as pay for overtime and employer pension contributions, which could make that data unreliable in identifying the lower quartile, median and upper quartile employee. This could be particularly important for companies with "grandfathered" defined benefit pension schemes.

Multiple employees with the same hourly rates

- The CEO ratio requires the identification of three individuals (lower quartile, median and upper quartile) for the comparison. However, companies will face a challenge when there are individuals with identical rates of hourly pay (for the gender pay comparison) at these three positions. In these circumstances, it would seem appropriate to produce the single figure data for the entire group on that hourly rate of pay, or to "intelligently sample" the group to find a person who, on a full-year, full-time equivalent basis, would appear an appropriate representative of the employees grouped at that particular rate of hourly pay.

Timing is key

- Gender pay gap reporting is designed to provide an annual snapshot as of 5 April each year, whereas the CEO pay ratio is designed to analyse pay over a full financial year. The precise timing of the payment of annual bonuses and the vesting of long-term incentives can, therefore, have a significant impact on the data. The median employee based on data for April (if this were primarily base salary) may actually be significantly above or below the median or quartile positions on an annual basis when the bonus is included in the calculations.
- A potential mis-match may also arise from benefits; for employees the most readily available data is the P11D to April. Accordingly, companies may choose to apply judgement in adding this figure for the full year FTE for employees, rather than seeking to estimate a calendar year value.

FIT Remuneration Consultants LLP

January 2019

If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111.