WHY COMPANIES NEED TO TRACK INTERNAL PAY EQUITY WITHIN THEIR OWN COMPANIES

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One of the primary questions garnering recent Compensation Committee attention has been how to strike the right balance between external market competitiveness and internal pay equity. Companies for most of the 1990s were almost slavish to the market, convinced they had to "pay what it takes to get good talent." Because CEO pay grew the most exponentially over the 1990s, the result has been CEO pay in many companies that is significantly out of step with pay for direct reports and other executives.

All of the major position papers on solving the current executive pay controversy from NACD to the Business Roundtable have suggested that relying strictly on market pay data to determine pay levels is not sufficient. Other, internal factors need to be considered as well. Yet, they offer no guidance on what these other factors might be or how to incorporate them.

The truth is, the answer to this balance is going to be different for every company based on their operating style and the relative strategic importance within the company of different roles. For instance, the degree to which the executive officers act as a team vs. have accountability isolated at the top might dictate very different internal pay ratios (i.e., the team oriented company might have tighter ratios, while the isolated accountability team might allow for larger spreads between executives). Likewise, a company that emphasizes the development of general management skills and rotates executives significantly across functions may require more internal pay equity than a company in which executives develop more functionally.

As an extension of this concept, we also believe that relative pay positioning for different jobs should take into account the strategic impact of a particular role within the company. Specifically, the more impactful the role is on company strategy/performance, the greater the pay opportunity should be. Consider two positions at XYZ Corporation: Head of Sales and Marketing and Chief Legal Officer. Let's assume both of these positions have a total direct compensation opportunity of $750,000 per year in the market. If the company's core strategy calls for brand development, gaining market share, and increases in profitable revenue growth, we could make the case that the company needs to pay a premium on the market to ensure a top level performer occupies the key Head of Sales and Marketing role. Conversely, if the company were involved in a legal settlement central to the ongoing viability of the company, pay positioning for the Chief Legal Officer might be more highly weighted than pay positioning for the head of sales and marketing. The pay opportunities for these two roles should be informed by market pay levels, but dictated more by the internal value of those roles to the business. In reality, market data represents a range of variations on the definition of a position, even though they may share a common job title. Although the market data provides useful guideposts, a market median may not be particularly relevant for the role of a particular position in a given company. The key point is that companies who rely solely on the market to differentiate pay levels are ignoring the more crucial question of “how important is this role to *my* business?” We call this concept Strategic Work Valuation and it is a context under which internal pay equity among the executive officers should be tracked and reviewed.

Need For A Historical Internal Pay Equity “Audit”

From a diagnostic standpoint, there is a tremendous amount of value that can be gained from evaluating the relationship between CEO pay and the pay of other executives over a long period of time (e.g., 10 to 25 years, depending upon data availability and time period relevance). This historical pay “audit”, which should be conducted both by pay component and overall, can provide important context for the Compensation Committee as to how the compensation program has evolved -- i.e., where the current program structure and mix have come from. This context can be instructive in helping determine where the design needs to go. As it works through the historical timeline, the Committee should seek to understand the influences in the organization that made certain changes necessary and then ask themselves whether the underlying rationale is still valid today. By looking at what is different and what’s the same, they can evaluate the roots of the current executive pay structure and levels.

Perhaps certain departures in the internal relationships took place along the way because of the need to bring in a CEO from the outside or because of the need to integrate executives in a merger, for example, leading to the introduction of special equity grants that later became built into the core compensation program. Perhaps an urgent business need created the need for a certain incentive that still is part of the program today, even though the need has since passed. Perhaps changes were made over time because of changes in the company’s ability to fund certain compensation elements – for example, greater equity grants were made because of below market retirement benefits, which have since been corrected, although the equity awards were never recalibrated.

Clearly, while some of these changes may have made sense at the time, they may not be the right answer for the future executive compensation design. Where unintended gaps between the CEO and other executives in the company are identified, corrective actions, including transitions to new designs and/or reductions of certain awards may be necessary. Perpetuating inequities can reduce program effectiveness and dampen employee morale and motivation.

Bottom line, the Committee needs to be comfortable that the current internal pay equity and changes in that pay equity over time make sense. By questioning whether the internal ratios make sense given the business context and the company’s operating style, Compensation Committees can have an informed discussion about the right philosophy and actions to pursue going forward.