Levels of Work and Internal Pay Equity – More Defensible than Executive Compensation Surveys

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Some leading executive compensation authorities are highlighting – for corporate boards and their members – the flaws and risks in the use and over dependence on external executive compensation surveys to set pay. As Fred Cook, chairman of Fredric W. Cook & Co., said in a recent CompensationStandard.com webcast: "We have been so dependent on surveys because we do not know how to value the job of management." (See excerpt on p. 3.) Surveys have also contributed to a compensation "ratcheting" effect, with many companies trying to be at the 75th pay percentile.

Many surveys are flawed because they are not truly comparing apples and apples, but instead apples and oranges … and sometimes even kiwis. Thus the true pay percentiles could be understated by 100 percent, depending on the peer group selected – pay percentiles that boards have disclosed in their proxy statements to shareholders.

As an example, the 2003 cash compensation for Johnson & Johnson's CEO was $3.2 million, compared with $2.6 million Eli Lilly paid its CEO. If taken at face value, it might be assumed that the Eli Lilly CEO role was underpaid. When you look under the surface with appropriate executive job analysis factors, however, the CEO role at J&J is over five times more complex than the CEO role at Eli Lilly.

When properly job-matched for the level of complexity and value-add of the role and then calibrated to reflect a role five time less complex, the *true* comparable J&J compensation for Eli Lilly's CEO would be $1.2 million – not $3.2 million. Therefore, boards should *not* accept the compensation data presented at face value and should ask if the data they are getting has been properly job matched and calibrated, and what methodology was used to do it.

A solution to this over-dependence on surveys is a framework called Levels of Work as well as related research on the Internal Pay Equity multiplier (or pay differential). Over the last 15 years there have been 13 research studies that investigated the relationship among differential pay, position in the hierarchy and the time-span of discretion of the role. These studies involved over 1,000 participants – from CEO to manager levels in the U.S., Canada and the U.K. – and identified that the "felt fair pay" and differential compensation between the real work in organizations consistently differed by a multiple of two. In other words, the research identified that each work level is worth two times more in total compensation than the level directly below it, if roles are designed properly and truly perform differential work.

So the best and easiest way for a board to set or calibrate CEO pay is to:

(1) analyze the work of the top three levels of management with defensible executive job analysis factor and related processes;

Definitions

Differential compensation:	Compensation that is fair and equitable given significant differences in job design and value-added contribution between levels of management or levels of work.
Felt fair pay:	What is seen as fair compensation for a role based on its job content, level of accountability and decision authority.
Time-span of discretion:	How far into the future a role has decision authority over resources and is held accountable for an outcome without seeking further manager or board approval.

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(2) ensure that each level is doing differential and value-adding executive work and not wasting compensation, using six executive job analysis factors; and

(3) take the average total direct compensation for Direct Reports Once Removed (employees reporting to the Named Executive Officers or the level of management who report directly to the CEO) and multiply by four to get the "Fair Pay Differential" for the CEO role.

Thus if the business unit president in a large global business (a Level 3 CEO) is earning total cash compensation of $960,000, then the total cash compensation for the global CEO (a Level 5 CEO) that is fair and seen as equitable is four times more, or $3.8 million. (See chart, below.) This is a simple check all boards should do to ensure they are fully informed before making any final executive pay decision.

Levels of CEO Work and Compensation

Pay Equity Multiplier

Level of General Manager Work and Innovation	Time-span for Planning	*Pay Equity Multiplier	Example Pay Bands $USD
Level 5 Global Business/Societal Innovator ***(Stratum 7)*	50 yrs	32X	$3.84m
	25 yrs		$2.88m
	20 yrs	**16X**	**$1.92M**
Level 4 Global Industry Structure Innovator *(Stratum 6)*	12 yrs		$1.44m
	10 yrs	**8X**	**$960,000**
Level 3 New Business Model Innovator *(Stratum 5)*	7 yrs		$720,000
	5 yrs	**4X**	**$480,000**
Level 2 New Product/New Market Innovator *(Stratum 4)*	3 yr		$360,000
	2 yrs	**2X**	**$240,000**
Level 1 Process Innovator *(Stratum 3)*			$180,625
	1 Yr	X	$120,000

* The multiplier identifies the value-added contribution of a general manager (GM) or CEO role and "felt fair pay" total compensation relative to a Level 1 GM/CEO role.

** Stratum as defined by Stratified Systems Theory (SST).