HayGroup®

Executive Briefing

Canada

Issue 6 | September, 2014 | Your executive compensation resource

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Executive job evaluation 2.0:

How is the value of a publicly traded company determined? According to financial theory, company value is equal to the present value of the projected dividends and/or retained earnings to be delivered to share-holders in perpetuity. In practice, company value is determined via the market. Because a company's income statement and balance sheet are assembled utilizing Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), an investor has information at his or her fingertips to assess company value and make a reasonably informed investment decision.

When it comes to people, arguably an organization's greatest assets, it can be more difficult to determine 'value.' The level of compensation and benefits provided to executives is determined by a combination of factors, including the market rate for talent for the type of job, the size and scope of the organization, and the industry. For example, a CEO of a $1 billion manufacturing company may be 'benchmarked' to competitor CEOs at other similarly sized manufac-turing organizations to determine a competitive market rate for talent.

However, by merely benchmarking pay to other jobs, an organization is not determining the value that the job will contribute to the organization, but rather the rate that the market suggests that the company must pay. A CEO at Company A is assumed to be essentially the same as a CEO at Company B. Other factors that impact job complexity are not considered, nor is the expected rate of return that the CEO will achieve for the company.

Valuing balance sheet assets vs. people 'assets'

Consider the following example, in which ABC Company is evaluating an acquisition prospect.

Elizabeth, chief financial officer of ABC Co., is considering whether or not to acquire a smaller manufacturing company. Bill, the chief human resources officer, is tasked with analyzing the competitiveness of the compensation currently provided to the executives of the acquisition prospect and developing a new compensation structure for the executives once the company is acquired.

Company value. Elizabeth knows that she must develop a reasonable estimate of the value of the company to be acquired. She employs such financial methodologies as discounted cash flow and the capital asset pricing model in order to determine a present value of the estimated future cash flows of the company. In addition, she examines industry data. She works with an outside valuation firm which supplies her with peer group data on industry multiples (e.g., market capitalization as a multiple of EBITDA). Lastly, she conducts projections of the return on investment the acquisition will provide over time, utilizing such calculations as net present value (NPV) and internal rate of return (IRR). Based on her financial analyses and calculations, supplemented with the valuation firm data, Elizabeth is confident that she has developed an accurate company valuation to assist the CEO and the board in making the right decision as to whether to proceed with the acquisition.

Executive value. Bill knows that he must understand the going rate for executive talent for a small company of this size in the manufacturing industry. He works with his compensation team and compensation consultant to conduct market pricing on the executive jobs. The compensation team matches each of the executives to pertinent job benchmarks in the manufacturing industry, scoped to companies of similar revenue size. The compensation consultant develops a publicly traded peer group and summarizes compensation data disclosed in proxy filings. With this data, Bill provides a report to the CEO and the compensation committee comparing the pay of the executives to the market. Lastly, he develops preliminary recommendations as to how the acquired executives would fit within the compensation structure.

Differences in analyses. We are all familiar with the mantra, "people are a company's greatest asset." Isn't it troubling then, that we have more rigorous methodologies available for valuing companies and physical assets than we do for people? Notice the focus of the CFO's analysis: it is on the return on investment (ROI) that the company will provide. The focus of the CHRO's analysis is on determining the 'market rate' for the executive talent – in other words, "we have to pay what the market dictates."

How then, can we develop a better methodology to value people? As organizations have developed more sophisticated approaches to managing their human resources, they are moving beyond a market pricing approach to a 'work valuing' approach by utilizing job evaluation in addition to market data.

Job evaluation 101

Job evaluation was developed out of the scientific movement of work factor analysis in the late 1940s/ early 1950s. The Hay Group Guide Chart Profile Method of Job Evaluation was initially developed by Edward N. Hay, in the early 1950s, as an out-cropping of the scientific movement. Mr. Hay, an engineer by background, desired to develop a system for quantifying the impact that jobs have on an organization. In its most basic form, job evaluation a system for determining the size of a job relative to other jobs in the organization. Beyond that, it is used to derive a market value for jobs of similar size. Rather than simply benchmarking to a 'job match', compensation data can be derived for a particular point value or range of point values.

Main factors in job evaluation. Hay Group's job evaluation methodology, which has been refined over the years to accord with new learning and developments, is comprised of three main factors: **1) know-how, 2) problem solving,** and **3) accountability**.

The three main factors can be represented by a simple model:

For any given job there is a relationship among the three factors. The OUTPUT, or end results expected of the job (the accountability), demands a certain level of INPUT (know-how) and processing of this know-how (problem solving) to enable delivery of the OUTPUT.

Job evaluation for executives

Compensation committees are certainly familiar with the process of compensation benchmarking from proxy statements which starts with developing a peer group (typically 12-20 companies in similar industries and of similar size). Compensation data so obtained then is summarized by job match or pay rank. The approach has become a standard analysis performed on an annual basis to benchmark the competitiveness of executive pay vs. the peer group companies. Proxy data certainly provides the compensation committee with a great deal of information, as more detail is disclosed in proxy statements than ever before.

Shortcomings of proxy analysis. While proxy analysis is a great tool for benchmarking pay, it falls short in several areas.

- Revenues alone do not predict compensation levels. Our research suggests that typical r-squared values for regressions of pay on revenue are 0.3 - 0.5, whereas r-squared values for pay on job evaluation points are in the range of 0.6 - 0.8 (r-square value of 0 indicates no relationship, r-squared value of 1.0 indicates a perfect relationship).
- When certain company job benchmarks do not exist in the peer group companies, executives are matched by their internal pay rank among the other NEOs. While this provides data on other similarly ranked executives, it fails to align with the job and complexity of the role.
- The approach fails to establish specific market rates for 'combined' or 'hybrid' roles (e.g., chief financial officer who is also the chief information officer). Blending job benchmarks may even 'discount' these types of roles, when the job may be inherently more complex and provide more value to the organization.
- Pay benchmarking does not provide any insight on the internal organization structure and succession planning.

- Job titles do not reflect the business strategy of the organization and how this impacts job size (e.g., low cost, high technology or high customer focus).
- Many organizations develop a compensation philosophy whereby they target a given market percentile vs. the proxy peer group, typically the market median. Paying at the median of the market is not always sound strategy as performance is then not a consideration. When assessing pay, it is important for there to be a strong performance connection. Market values are merely a point of reference and should not be deemed to be a mandate.

Other factors. In determining the value of executive jobs through the process of job evaluation, the following factors are considered:

- **Industry** – the nature of the industry, unique industry challenges, and the degree of regulation have an impact on job complexity
- **Revenues** – good predictor of job size within an industry and are one of the key factors utilized in determining the level of executive accountability, but value added (revenues minus purchases) are also a consideration. Assets – often utilized to determine executive accountability in financial services or insurance companies but also relevant for industrial companies
- **Employee headcount** – an important measure, but an organization should be careful to use full-time equivalents; also location and reliance on technology can affect cost
- **Governance** – clearly has impact on the top job (e.g., CEO vs. CEO and chairman combined)
- **Geographic scope of company** – adds complexity, and thus job size (e.g., just domestic operations vs. international operations)
- **Market capitalization** – a risky, unstable measure, and not directly used in job evaluation, but can give a perspective on accountability
- **Organization strategy** – affects the relative value of positions below the CEO (i.e., NEOs)

Once these factors are utilized to develop job evaluation point values for the CEO and other executives, more precise market data can be collected that better reflect specific job accountabilities (vs. using a benchmarking only approach). In addition, job evaluation has applications for managing executive talent beyond determining competitive compensation levels:

- Developing a compensation structure (e.g., grades or broad-bands)
- Succession planning (job evaluation is linked to competencies and behaviors, executives can be assessed vs. what is required for their role and the next role)
- Linking executives to the organization strategy by describing their specific accountabilities and the nature of how they impact the accountabilities (e.g., developing a clear plan for implementing the strategy)

- Defining the impact of acquisitions, joint ventures, matrix organizational structures (e.g., the executives in an acquired company may not be compensated to the same degree as a stand-alone company)

'Pay ratio' applications

With the pending implementation of the CEO pay ratio rule, publicly traded companies are struggling with both how they will calculate the ratio of CEO pay to the median pay of all other workers, as well as how they will manage the public and media reaction. Certainly, there is little, if any, business value that can be derived from this simplistic ratio. However, this is not to say that companies are not concerned with internal equity of compensation.

Our research suggests that employees are often more concerned with being paid fairly compared to their colleagues performing similar jobs, rather than compared to the external marketplace.

Job evaluation enables organizations to not only consider the external competitiveness of pay vs. jobs of similar size, but to examine the degree of internal equity.

Companies utilizing job evaluation have the ability to assess more meaningful pay ratios among the top executive team (e.g. CEO to CFO, CEO to COO, etc.) vs. industry specific pay ratio standards. Lastly, an internal equity assessment can be cascaded down through the entire organization to determine the degree of internal correlation between job size and pay.

Summary

While employees are not really 'assets' in the financial sense as the company does not 'own' them, they are important resources in adding value to the enterprise in terms of setting and executing strategies using financial, intellectual, and physical assets. In determining 'good will' (or the value of an enterprise over its book value), the quality of the leadership team is an important consideration. To value the quality of executive talent, organizations need to move beyond market pricing to work valuing. Depending on the objective of the desired analysis, a company may need market pricing, job evaluation, or both.

This article was originally published in the Executive Edition, HayGroup's resource on executive compensation matters.

To read this newsletter in its entirety or for additional information on this topic, please visit **www.haygroup.com**.

We would like to thank Adam Kahle for his contributions to this article.

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Executive Briefing Canada

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