

Heads Up

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For What It's Worth SEC Proposes Rule on Pay Versus Performance

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The SEC recently issued a [proposed rule](#)¹ that would amend Regulation S-K, Item 402,² to implement a mandate under the Dodd-Frank Act³ requiring a registrant to disclose the relationship between executive compensation actually paid and the financial performance of the registrant. The proposal, which is intended to improve shareholders' ability to objectively assess the link between executive compensation and company performance, raises a number of interesting questions and challenges.

In the proposal, the SEC has requested comments on 64 questions. Thus, it is unclear what the final rule will look like and when it will be issued (although if finalized before year-end, it may be effective for the 2016 proxy season). What is clear, however, is that shareholders, employees, and the media will heavily scrutinize the disclosures a registrant provides under the final rule. Comments on the proposal are due by July 6, 2015.

Tabular Disclosure

The proposal requires a registrant to present a tabular disclosure for each of its last five completed fiscal years. Under the proposed transition provisions, the registrant would initially disclose only three years of information but would include an additional year of data in each of the two subsequent annual filings (to satisfy the five-year requirement). The proposal provides the following example of the required tabular disclosure:

Pay Versus Performance						
Year (a)	Summary Compensation Table Total for PEO ⁽⁴⁾ (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for Non- PEO Named Executive Officers (d)	Average Compensation Actually Paid to Non- PEO Named Executive Officers (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return (g)

¹ SEC Proposed Rule Release No. 34-74835, *Pay Versus Performance*.

² SEC Regulation S-K, Item 402, "Executive Compensation."

³ The proposed rule would implement Section 14(i) of the Securities Exchange Act of 1934, as added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

⁴ Principal executive officer.

Editor’s Note: Many companies may find it challenging to determine (1) where to present this disclosure and (2) how to integrate it into the other extensive compensation disclosures already required by SEC rules. The proposal acknowledges that placement of the disclosure in the compensation discussion and analysis (CD&A) section of a filing would suggest that the relationship of pay to total shareholder return was a factor in establishing compensation, which may not be the case. Therefore, under the proposed rule, companies retain the flexibility to place the required disclosure wherever they believe it is most appropriate in the proxy. In addition, companies may continue to compute and present other performance measures, such as realizable compensation (as defined), that will allow them to “tell their own story” elsewhere in the CD&A.

Specific aspects of the tabular disclosure are discussed below.

Executive Officers

The executive officers under the proposed disclosures are the named executive officers (NEOs) as specified in Item 402.⁵ Individual compensation amounts would be disclosed only for the PEO; average compensation would be disclosed for the remaining NEOs.⁶

Editor’s Note: Although the SEC believes that averaging the compensation of non-PEO NEOs would alleviate concerns about year-over-year and cross-company comparisons, changes in the NEOs reported in the proxy each year could have a significant effect on annual changes to average compensation for the non-PEOs. Similarly, the inclusion of more than one PEO’s compensation during a transition year in the tabular disclosure could distort the compensation value for that year and impair a financial statement user’s ability to draw meaningful conclusions from the analysis.

Even in cases of PEO and NEO stability over a number of years, the value of compensation actually paid lacks any context without peer or industry pay comparisons. For example, the disclosure of a strong correlation between pay and performance does not provide shareholders with a way to evaluate whether the level of pay is reasonable relative to the compensation practices of the registrant’s peer group.

Summary Compensation Table Totals

Totals from the summary compensation table (SCT) would be obtained from the disclosure a registrant must provide under Item 402(c).

Compensation Actually Paid

The Dodd-Frank mandate differs from other aspects of the Item 402 disclosure requirements by focusing on compensation actually paid. To derive this amount (an individual amount for the PEO, and the collective average for the other NEOs), a registrant would need to make certain adjustments to the

⁵ Regulation S-K, Item 402(a)(3) (Item 402(m)(2) for smaller reporting companies).

⁶ If more than one person served as the PEO during a particular fiscal year, the compensation of all PEOs would be aggregated in the disclosure.

compensation totals reported in the SCT and disclose the nature of those adjustments in footnotes to the new tabular disclosure. For example, adjustments would need to be made to:

- *Pension amounts* — A registrant would first deduct from the SCT totals the aggregate change in the actuarial present value of the accumulated benefit under all defined benefit and actuarial pension plans reported in the SCT.⁷ It would then add back the service cost for those officers under all of those pension plans attributable to services rendered during the specified fiscal year. By making these adjustments, the registrant would essentially exclude all changes in the pension amounts that are not attributable to the applicable year of service. Notably, this adjustment would also eliminate significant changes in the present value of the pension as a result of the change in interest rates.
- *Equity awards* — The proposal notes that equity awards would “be considered actually paid on the date of vesting [and should be] valued at fair value on [the date of vesting] rather than fair value on the date of grant as required in the [SCT].” Fair values would be determined in accordance with the FASB’s guidance on equity award valuation (i.e., ASC 718⁸). Accordingly, a registrant would (1) deduct from the SCT total compensation amounts for awards of stock and options that are computed at aggregate grant-date fair value and (2) add back the vesting-date fair value of all stock and option awards that vested during the covered fiscal year. The proposal also requires a registrant to describe any valuation assumptions that are materially different from those used to compute the compensation amount included in the SCT in a footnote to the pay-versus-performance table.

Editor’s Note: The computation of compensation actually paid would be as follows:

SCT total compensation
Less: Change in pension value disclosed in the SCT
Less: Grant-date fair value of stock and option awards disclosed in the SCT
Plus: Service cost under all defined benefit plans for services rendered during the year
Plus: Vesting-date fair value of equity awards that vested during the applicable year

The “add-back” adjustments related to pension and equity awards are not required disclosures under the current compensation disclosure rules. As the proposal states, the SEC believes that the “valuation of options as of a different date and the required computations with respect to pension plans can be accomplished by entering new inputs into the existing valuation models used to calculate currently disclosed values.”

Use of the Black-Scholes model (or other option pricing models) to value stock options as they vest does not take into account the amount an executive could actually realize at the time of vesting (e.g., options could be underwater but a positive amount for paid compensation could still be reported under Black-Scholes). Therefore, it is possible that the proposed valuation method could lead to a decrease in the use of stock options unless the SEC ultimately decides to require use of a different valuation method, such as intrinsic value at the vesting date (i.e., the difference between the fair value of an option on the date of vesting and the option exercise price).

Total Shareholder Return

The method for determining total shareholder return (TSR) under the proposal is the same as that used in Regulation S-K, Item 201(e).⁹ That is, a registrant would divide “the (i) sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the registrant’s share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period.”

⁷ Such amount is only deducted if it is a positive amount.

⁸ FASB Accounting Standards Codification Topic 718, *Compensation — Stock Compensation*.

⁹ SEC Regulation S-K, Item 201, “Market Price of and Dividends on the Registrant’s Common Equity and Related Stockholder Matters.”

Under the proposal, a registrant uses the same method to compute the cumulative TSR for both itself and its peer group for each fiscal year included in the table. For peer group computations, a registrant uses the index or issuers it uses for either the performance graph disclosure required by Item 201(e) or the group used for compensation benchmarking practices in the CD&A.¹⁰ The TSR of each peer in the group would be weighted by each peer's respective stock market capitalization at the beginning of the measurement period.

Cumulative TSR for each fiscal year would be measured as a change from an initial, fixed investment. No averaging of stock prices is permitted. TSR would be based on the closing stock price on the last day of the applicable fiscal year.

Editor's Note: TSR is perhaps the most objective and transparent performance metric available for measuring long-term financial performance. Assessing TSR over a five-year period gives a clear illustration of long-term performance. Further, unlike the disclosures of compensation actually paid, which do not include peer comparisons, the TSR disclosure enables a registrant to select a suitable peer group for comparison purposes, giving both flexibility to the registrant and important context for evaluating a registrant's relative performance to the financial statement user. Because TSR is weighted by market capitalization, companies will need to be careful about using the compensation peer group for TSR purposes because one or two companies with high market capitalizations could distort the peer group's TSR.

Other Disclosure

In addition to providing the tabular disclosure, a registrant would be required under the proposal to clearly describe the relationship between the following:

- The executive compensation actually paid to the NEOs and the registrant's TSR.
- The registrant's TSR and the peer group's TSR.

Editor's Note: Attempting to explain the relationship between paid compensation and TSR (or lack thereof) will be quite challenging because most compensation decisions do not revolve around TSR. Further, the lack of alignment between the TSR measurement period (fiscal year) and the vesting period of the majority of long-term incentive plans (under whose terms, in most cases, awards vest in February/March for calendar-year companies) may magnify this challenge and encourage boards to shift vesting schedules closer to year-end to increase the overlap between the timing of the performance period and award valuation.

The proposal indicates that this description should follow the tabular disclosure; however, it does not specify the format of the description and states that it could be narrative, graphic, or a combination of both. For example, it could consist of "a graph providing executive compensation actually paid and change in TSR on parallel axes and plotting compensation and TSR over the required time period." Alternatively, a registrant could describe the relationship by "showing the percentage change over each year of the required time period in both executive compensation actually paid and TSR together with a brief discussion of that relationship."

¹⁰ If a registrant's peer group is not a published industry or line-of-business index, the registrant must identify the issuers in the peer group.

The proposal also requires registrants to electronically tag the disclosure by using XBRL¹¹ and to include the interactive data files “as an exhibit to definitive Schedule 14A . . . or definitive Schedule 14C” (as applicable). Specifically:

- Each amount included in the tabular disclosure would be tagged separately.
- Block-text tags would be applied to:
 - Footnotes to the tabular disclosure describing (1) the adjustments made to compute the executive compensation paid and (2) any material differences in the valuation assumptions used for equity awards.
 - The description of the relationship between (1) executive compensation actually paid and the registrant’s TSR and (2) the registrant’s TSR and the peer group’s TSR.

Smaller Reporting Companies

The proposal provides certain relief to smaller reporting companies.¹² Such companies would:

- Need to provide only three years of information instead of five years.
- Not need adjust executive compensation actually paid for amounts related to pensions.
- Not need to disclose the TSR of their peer group.
- Upon initial adoption, need to provide information for only two years of data instead of three (and three years in all subsequent filings).
- Not be required to provide interactive data in an XBRL format until their third filing that includes the pay-versus-performance disclosure.

Exceptions

Foreign private issuers, emerging growth companies, and registered investment companies would be exempt from the requirements.

Next Steps

Because of the potential sensitivity associated with any disclosures about executive compensation, registrants affected by the proposal should review their past compensation practices and assess whether the proposed requirements would appropriately convey to investors the relationship between their executive compensation practices and company performance. One way of doing so might be to model the proposed disclosures by using data for the past several years. Modeling might reveal possible unintended consequences of the proposal or the need to develop a strategy for communicating to investors the effects of specific aspects of the disclosures. Because the proposal requests comment on virtually all aspects of its provisions, registrants will have the opportunity to express their concerns and recommend improvements or disclosure alternatives.

¹¹ eXtensible Business Reporting Language.

¹² SEC Regulation S-K, Item 10(f)(1), "Smaller Reporting Companies," defines smaller reporting companies.

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