

Client Alert

January 3, 2007

SEC Adopts Changes to the New Executive Compensation Disclosure Rules

Changes More Closely Align Proxy Reporting with Accounting Rules

On December 22, the Securities and Exchange Commission (SEC) issued significant revisions (the "Revision")¹ to its new executive compensation rules in an effort to more closely align the reporting of equity awards with the accounting treatment required by the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004) Share-Based Payments (FAS 123R). For those keeping track, that's another 53 pages added to the 436 pages of the final rules issued in August. The Revision was issued as an interim final rule, effective immediately upon publication in the Federal Register. While the SEC is soliciting comments for 30 days following this publication, the Revision will apply upon publication for the 2007 proxy season.

PM&P Observation: *Although the Revision is effective immediately, the SEC could further amend the final rules based on comments received. Given the timing involved, it is possible that companies could file their proxy statement under interim rules that are subsequently revised, creating a disconnect between 2007 and 2008 filings.*

By way of background, following issuance of the proposed executive compensation rules released at the beginning of the year, the SEC received numerous comments regarding how to report the dollar value for Stock Awards and Option Awards in the **Summary Compensation Table** (SCT). Some of the comments expressed support for requiring companies to report the full grant date fair value in the fiscal year of the award, while other comments favored requiring disclosure of the proportionate amount (based on the recognition principles of FAS 123R) of an award's total fair value that is recognized in the company's financial statements for the fiscal year.

In its release of the original final rules in August, the SEC decided that reporting full grant date fair value in the SCT in the year of grant painted the most accurate picture of a company's executive compensation program. In the Revision, however, the SEC retreated from this position and is now requiring disclosure of the compensation cost of equity awards over the requisite service period in the SCT, stating that this amendment will provide investors with "more complete and useful disclosure."

¹ SEC Rel. No. 33-8765; 34-5509 (Dec. 22, 2006), at <http://www.sec.gov/rules/final/2006/33-8765.pdf>

As a result of the Revision, the SCT will now more closely track equity award values actually earned by a Named Executive Officer (NEO) in a given year and reported by a company in its financial statements. The full grant date fair value of these equity awards will now be reported in the **Grant of Plan-Based Awards Table** (Grant Table) and footnotes to the **Director Compensation Table**. This change may have a significant impact on the individuals who are included in the NEO group. Our initial thoughts are that the Revision will stabilize the NEO group by mitigating the impact of large equity awards made in a single year.

***PM&P Observation:** While some commentators have criticized this last-minute change as a holiday gift to companies at the expense of investors, the changes could in fact reduce or increase the total compensation value that would have been reported under the original final rules, as explained below. Moreover, the full grant date fair value will continue to be reported in a supplemental proxy table.*

Revision Details

The significant details included in the Revision are as follows:

- Stock and Option Awards Columns Values in the SCT: Companies must now disclose the compensation cost of such awards as provided in FAS 123R (disregarding the impact of service-based forfeitures, as described below), rather than including the full fair value in such columns as contemplated by the original final rules. This change will have a significant impact on the Total compensation column, which is used to determine which individuals (other than the CEO or CFO) are NEOs.
 - **Service Forfeitures Disregarded for Determination of Value in Year of Grant, but Included in Year of Forfeiture:** In determining compensation cost, FAS 123R generally requires a company to estimate at the grant date the number of awards that ultimately will be earned. These estimates are revised each period as awards vest or are forfeited. The Revision requires disclosure without regard to an estimate of forfeitures related to service-based vesting conditions. However, if the award is later forfeited, the amount of compensation cost previously disclosed in the SCT will be deducted in the period in which it is forfeited. Disclosure for such year could be negative if the forfeiture is greater than the FAS 123R value of other awards recognized that year.

***PM&P Observation:** This change resolves the problem that arose under the original final rules, by which a terminated executive could become an NEO solely by virtue of an equity grant that was disclosed on the basis of its full fair value, but which was subsequently forfeited upon the NEO's termination.*

- **Equity vs. Liability Awards:** The new classification of awards as either an “equity” or a “liability” award is an important accounting distinction that affects the measurement of compensation cost recognized in each financial statement reporting period. Awards with cash-based settlement are classified as “liability” awards under FAS 123R, including cash-settled stock appreciation rights; certain repurchase features; or other features that do not result in an employee bearing all the risks and rewards normally associated with share ownership for a specified period of time. Awards accounted for on an “equity” basis (i.e., those awards that are generally associated with share ownership) will generally be reported as equal to the grant date fair market value of the award spread over a requisite service period. Generally, the grant date value of options and restricted stock will be reported in the SCT as they vest. Disclosure for “liability” awards are not fixed and will reflect both the likelihood of vesting, as well as annual changes in market value. Introducing a distinction between “equity” and “liability” awards is another means by which the Revision more closely aligns executive compensation disclosure with accounting rules.

PM&P Observation: Nuances that are important for accounting purposes may significantly impact compensation disclosures, while relatively immaterial provisions may have a disproportionate impact on disclosure. For example, late in 2005, major accounting firms grew concerned that fairly typical equity grant provisions that provided for the settlement of stock options in cash upon a change-in-control would qualify such grants as liability awards under FAS 123R. While the FASB took corrective action in early 2006 to address this issue, it illustrates how a relatively immaterial and benign provision may produce unintended and potentially material results that could flow through to the disclosure requirements. Since 2006 is the first full year of FAS 123R compliance for most companies, there may be other surprises in store as companies and their auditors become more familiar with the new options accounting rules.

- **Performance-Based Awards:** The Revision requires that companies estimate, at grant, the portion of performance-based awards that are likely to be earned. Proportionate reporting in the year of grant and future years will only occur to the extent that achievement of such conditions is probable. Reported compensation may change over time if the probability of achieving the condition changes.

PM&P Observation: This change addresses a major concern voiced in comment letters to the SEC regarding the potential for over-reporting under the original final rules – that performance vesting awards would need to be reported in their entirety in the year of grant, with no opportunity to reverse the value if the performance criteria ultimately were not achieved. However, increases and decreases in stock price for liability awards, as well as variances in the probability of achievement of performance, may increase or decrease reported compensation and also may affect who is an NEO.

PM&P Observation: These columns may report negative compensation which, unlike negative amounts in the Change in Pension Value column, would be subtracted from the Total compensation column amount, which in turn determines the NEOs.

- **Grants to Retirement-Eligible Individuals:** Under FAS 123R, awards made to retirement-eligible employees who are entitled to retain their awards upon retirement are not considered to have a substantive service requirement, and therefore the full grant date fair value of the award must be reported for such individuals in the year of grant. While this results in the same treatment of grants to these individuals as under the original final rules, it will now make grants to such individuals appear inflated compared to identical grants to individuals who are not retirement-eligible and may impact who is an NEO.
- **Grants of Plan-Based Awards:** A new column called “Grant Date Fair Value of Stock and Option Awards” has been added to the far right of the Grant Table that will report the full fair value of the equity award. Those amounts will be reported on a grant-by-grant basis, rather than being reported annually on an aggregate basis in the SCT, as required by the original final rules. For the **Director Compensation Table**, the full value will be reported in a footnote.

PM&P Observation: Effectively, the Revision simply moves reporting of the full grant date value of equity awards from the SCT to the Grant Table. Thus, each year companies may potentially report the grant of equity in four different places: (i) annual vesting value in the SCT; (ii) annual grant value in the Grant Table; (iii) fiscal year-end “in the money” value in the Outstanding Equity Awards table; and (iv) annual realized value in the Option Exercises and Stock Vested table.

- **Option Repricings:** The original final rules required that the incremental value attributable to repricings or other modification be included in the SCT. The Revision now requires that such incremental value be included in the new column in the Grant Table, where it will be reported on a grant-by-grant basis. This incremental value, however, will “flow through” the SCT in subsequent years based on the vesting schedule. The requirement that an explanation of such repricings be provided in the narratives to the tables or in the Compensation Discussion and Analysis, however, remains unchanged.
- **Reporting of Salary or Bonus Foregone Upon Executive Election to Receive Non-Cash Compensation:** In the original final rules, companies were not required to report the value of salary or bonus in the Salary or Bonus columns to the extent that they were foregone at the election of the executive in exchange for non-cash compensation. Instead, such awards were required to be reported in the more appropriate column of the SCT (i.e., the Stock, Option or Non-Equity Award columns), and simply footnoted in the Salary or Bonus column. The Revision now requires that such amounts be reported in the Salary or Bonus column, regardless of an executive election to receive non-cash compensation. In addition to this disclosure, information with respect to the actual non-cash award that was made must be reported at full fair value in the new column of the Grant Table.

PM&P Observation: *The unintended result of this change may be double counting in the SCT. The award initially will be reported in the table in the year of grant as Salary or Bonus, and then will run through the SCT in later years as the non-cash award becomes reportable in the company's financial statements, if subject to vesting.*

- **Timing of Award Reporting:** Under the original final rules, determination of the timing of awards was critical because their entire value was reported in the year of grant. The Revision instead requires that companies follow FAS 123R rules in determining the proper year of reporting. This could result in situations where compensation cost is recognized and reported in the year before the award is granted (e.g., where an employee is rendering services in exchange for an award whose terms are not finalized), or where the grant has been made but the compensation cost is not recognized or reported in that same year (e.g., where a performance condition is not probable on the date of grant).
- **Inclusion of Awards Granted Prior to 2006:** The Revision includes a new requirement that the SCT capture values attributable to equity based grants made prior to 2006. Companies must use FASB's "modified prospective transition method" for disclosure purposes with respect to such prior awards, even if the company has not adopted that method for accounting purposes. As a result, the SCT will include a proportionate share of the grant date fair value of prior awards that were outstanding at the date FAS 123R was adopted, which will be reported over the remaining vesting periods.

PM&P Observation: *While the Total compensation column amounts for 2006 will decrease due to recognition under FAS 123R of the requisite service period, this decline could be offset by recognition of prior awards vesting in 2006. In fact, there may be cases where the annual expense of all equity vesting in 2006 is higher than the full grant date value of the awards made in 2006, resulting in higher Total compensation under the Revision. Companies that accelerated vesting of their options prior to adoption of FAS 123R will not need to disclose past grant values, however.*

- **Parallel Amendments to Director Compensation Table:** The concepts described above are applied in a similar fashion to the Director Compensation Table and its accompanying footnotes and narratives.

What To Do Now

- Review and revise mocked up SCT and Grant Tables to include the new requirements. This will necessitate close coordination with the financial accounting function to ensure coordination of FAS 123R costs. Remember to include FAS 123R values using the “modified prospective transition method” for grants made prior to 2006.
- Determine if the Revision will affect the NEO group originally slated for inclusion in the SCT. In almost all cases, the Revision will impact the Total compensation reported in the SCT, which governs determination of NEOs other than the CEO and CFO.
- Pay special attention to equity grants made to employees who are eligible to retire, which may have a significant impact on whether such retirement-eligible individuals are considered NEOs or whether others not eligible to retire drop out.
- Going forward, be prepared to explain potentially significant year-to-year variances in liability and/or performance-based awards as compared to amounts reported in previous years.
- Pay special attention to determination of potential NEOs, which may be affected by a number of provisions included in the Revision. Going forward, a larger group of potential NEOs may need to be tracked.

PM&P will be revising its earlier analysis of the complete executive compensation disclosure rules to include this new development and will post the changes to our website.

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