

# Defining Issues<sup>®</sup>

KPMG LLP



## SEC Adopts Revised Executive Compensation Disclosures

Newly adopted SEC rules require companies to report more data on executive and director compensation, including the total annual compensation of the principal executive and financial officers, the three other highest paid executive officers, and the company's directors.<sup>1</sup> The adopted rules, which do not differ greatly from what had been proposed in January, also revise the guidance on identifying perquisites and the disclosure requirements for "related person" transactions, officers' and directors' equity ownership, director independence, and the functions of board committees. The requirements affect disclosure in proxy statements, annual reports, registration statements, and Form 8-K reports. Effective dates vary, beginning as early as 59 days after the rules are published in the Federal Register.

In a related action, the SEC decided to modify and re-expose its proposal to require compensation disclosure for up to three highly compensated employees in addition to those executives just described.

This edition of *Defining Issues* summarizes the main features of the new rules for companies that are not small business or foreign private issuers. Issuers subject to Regulation S-B may provide less extensive disclosures. Foreign private issuers may continue to follow the compensation-disclosure requirements in Form 20-F, but must disclose more detailed information if it is made publicly available for some other reason, such as a home-country requirement. The potential effect of the new rules on compliance obligations is a legal matter on which companies should consult their securities counsel.

### Executive and Director Compensation

The rules refine and expand the currently required tabular disclosures and add a new discussion-and-analysis section. A total compensation amount and its components must be disclosed for the directors and for the principal executive and financial officers and the three other highest paid executive officers (collectively, the "named executive officers"). The key determinants of the company's compensation decisions must be explained, and all the elements of compensation must be included in the tables. Disclosures must be presented in plain English.

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<sup>1</sup> SEC Release No. 33-8732, *Executive Compensation and Related Person Disclosure*, August 11, 2006, available at <http://www.sec.gov/rules/final/2006/33-8732.pdf>.

## Differences Between the Adopted and the Proposed Rule

The SEC adopted the rules substantially as proposed, but modified some provisions in response to comments. The effect of some of these changes was to:

- Eliminate the provision that would have required companies to disclose the total compensation of no more than three employees who are not named executive officers if their total compensation exceeds that of any of the named executive officers. The proposed provision will be revised to limit these disclosures to individuals who have responsibility for significant policy decisions, and the revisions will be exposed for public comment.
- Expand the tabular and narrative option-grant disclosures to highlight grants with an exercise price below the grant-date market price and to include an analysis and discussion of matters such as the reasons a company selects particular grant dates for awards and the methods a company uses to select the terms of awards (e.g., the exercise prices of stock options).
- Relocate the stock performance graph to Item 201 of Regulation S-K.
- Clarify the term "actuarial value" of pension benefits to relate it to the "accumulated benefit," a term used in determining financial-reporting amounts under GAAP, and provide guidance on how to calculate the amount.
- Revise the requirement for equity-based awards that have been modified to require the increase in fair value, rather than the total modification-date fair value, to be disclosed in the Summary Compensation Table.

### **Compensation Discussion and Analysis.**

Compensation disclosure will now begin with a narrative Compensation Discussion and Analysis (CD&A) section that describes the most important determinants of the company's compensation policies and decisions. This section is intended to set the context for the tabular material that follows. The presentation will cover the company's compensation objectives, what its compensation program is designed to reward, the elements of compensation, why the company chooses to pay each element, how amounts for each element are determined, and how each element and the compensation decisions fit into the company's overall compensation objectives. The disclosure should be sufficiently precise to identify those compensation policies and decisions unique to individual named officers.

This discussion-and-analysis section should also analyze and discuss information about option grants to executives, such as the reasons a company selects particular grant dates for awards, and the methods a company uses to select the terms of awards, such as the exercise prices of stock options. Companies must disclose any program, plan, or practice it has had in the previous or current fiscal year, or plans to have in the current fiscal year, for selecting option grant dates for executive

officers in coordination with the release of material information. Similarly, a company should disclose a program, plan, or practice of awarding options if the exercise price is set based on the stock price on a date other than the grant date or based on a formula using an average or lowest price of the stock in a period preceding, including, or following the grant date. The rules provide additional guidance on these types of disclosures.

The discussion-and-analysis section will be filed with the SEC, subject to liability under the Exchange Act, and subject to certification by the company's chief executive and financial officers. A new Compensation Committee Report must be furnished that states whether the compensation committee has reviewed and discussed the discussion-and-analysis section with management and whether it recommended that the section be included in the company's annual report on Form 10-K and proxy statement.

Revised tables containing compensation amounts will cover total compensation in each of the last three years, holdings of equity-based interests that relate to or are potential sources of future compensation as of the fiscal year-end, and retirement and other post-employment compensation,

including retirement and deferred compensation plans, other retirement benefits, and other post-employment payments. Some items of compensation may appear in the Summary Compensation Table and one or more of the other tables. The SEC release encourages the use of the narratives following the tables (and within CD&A) to explain how disclosures relate to each other.

**The Summary Compensation Table.** This reorganized table is intended to disclose all annual compensation for each named executive officer for each of the last three years. It will present the information about the following elements of compensation for each of those individuals, whether or not actually paid:

- Annual salary and bonus (both already required to be disclosed). If salary or bonus cannot be calculated as of the most recent practicable date of the filing, a current report on Form 8-K will be triggered by a subsequent payment, decision, or other occurrence that enables either the salary or the bonus to become calculable in whole or part. The Form 8-K will disclose the salary or bonus amount and a new total compensation amount.
- Stock and option awards granted or modified during the year shown in separate

## Summary Compensation Table

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
PEO	—								
	—								
	—								
PFO	—								
	—								
	—								
A	—								
	—								
	—								
B	—								
	—								
	—								
C	—								
	—								
	—								

columns at their total grant-date fair value, computed according to Statement 123R's requirements.<sup>2</sup> If awards are repriced or otherwise modified during the year, the amount presented should include the incremental fair value computed as of the repricing or modification date. The grant-date fair value of reload or restorative options should be included in the table since those awards are treated as new grants under Statement 123R. Stock awards include awards that derive their value from the company's equity securities or permit settlement by issuance of the company's equity securities (for example, restricted stock and phantom stock awards). Option awards include options, stock-appreciation-rights, and similar stock-based compensation instruments that have option-like features. A footnote will disclose assumptions made in valuing these awards by referring to the discussion of the assumptions in the notes

to the company's financial statements or in Management's Discussion and Analysis.

- The monetary value of all amounts earned during the year from compensation awarded under incentive plans that are not equity-based arrangements within the scope of Statement 123R. Unlike stock and option awards, which are included in the table at their aggregate grant-date fair value, compensation from non-equity incentive awards will be disclosed in this table in the year that the specified performance criteria under the plan are satisfied and the compensation is earned, whether or not payment is actually made in that year. In the year of grant, however, these awards will be disclosed in a supplemental Grants of Plan-Based Awards Table.
- The aggregate increase in the actuarial present value of the accumulated benefit under all defined benefit pension plans and above-market or preferential earnings

on nonqualified deferred compensation. However, these amounts are not included in total compensation for purposes of identifying qualifying named executive officers. Each element should be identified in a footnote that also quantifies the full amount. Any amount attributable to the defined benefit plans that is a negative number should be disclosed by footnote, but not reflected in the amount reported in the column. The above-market or preferential portion of deferred compensation earnings is determined for interest by reference to 120% of the applicable federal long-term rate and for dividends by reference to the dividend rate on the company's stock. The company's criteria for determining any portion considered to be above-market may be disclosed in a footnote or in the narrative disclosure. This table will include only the above-market or preferential portion of earnings. However, the separate Nonqualified

<sup>2</sup> FASB Statement 123 (revised 2004), Share-Based Payment, December 2004, available at [www.fasb.org](http://www.fasb.org).

Deferred Compensation Table will include all earnings on nonqualified deferred compensation.

- All other compensation not already subject to disclosure under the requirements just described, for example: company contributions or other allocations to vested and unvested defined-contribution plans, tax reimbursements, life insurance premiums, and perquisites and other personal benefits. Each of these elements of compensation would have to be identified and quantified in a footnote if its amount is \$10,000 or more. Each named person's perquisites and other personal benefits must be individually identified and quantified if their value exceeds \$25,000 or 10 percent of his or her total perquisites and other personal benefits. The previous threshold for disclosing perquisites was the lesser of \$50,000 or 10 percent of total annual salary and bonuses. The rules provide guidance for determining what constitutes a perquisite.
- Total aggregate compensation.

Currently payable compensation amounts that have been deferred for any reason must be included in the appropriate column. The amount deferred will also generally be reflected as a contribution in the Nonqualified Deferred Compensation Table.

The Summary Compensation Table will be accompanied by the Grants of Plan-Based Awards Table and a narrative that helps explain the compensation information presented in the tables. The narrative will describe any additional material factors necessary to understand the information disclosed in those tables. Material factors to be disclosed in this section will vary, but may include material terms in the named executive officers' employment agreements, any modification to an outstanding stock-based compensation award, and award terms relating to plan-based awards.

The disclosures of award terms may, for example, include a general description of the formula or criteria applied in determining the amounts payable, the vesting schedule, performance-based conditions, whether dividends or other amounts will be paid, the applicable rate, and whether that rate is preferential.

***The Grants of Plan-Based Awards Table.***

This table will supplement the Summary Compensation Table by disclosing the terms of grants of plan-based awards to the executives made during the current year, including estimated future payouts, for both equity incentive and non-equity incentive plans, with separate disclosure for each grant. The estimated future payout columns should disclose the threshold (minimum) and maximum payouts along with a target payout. A target refers to the amount payable if the specified performance targets are reached. If only a single estimated payout is to be disclosed, the amount is reported as the target. If the target is not determinable, registrants must provide a representative amount based on the previous fiscal year's performance. Separate, adjoining columns must be added to the table if the closing market price on the grant date is greater than the exercise price of the award and/or if the date action was taken by the compensation committee or full board of directors to grant the award is different from the grant date as determined according to Statement 123R. If the exercise price is not the grant date closing market price, the registrant should describe the methodology for determining the exercise price either by a footnote to the table or in the accompanying narrative section.

***The Outstanding Equity Awards at Fiscal Year-End Table.***

This is one of two tables designed to communicate information about the executives' outstanding equity interests. It will present details of option awards for both exercisable and unexercisable options,

including the exercise price and the expiration date for each outstanding award as of the company's most recent fiscal year-end. It will also show the number of shares underlying each unvested stock award along with the related market value.

***The Option Exercises and Stock Vested Table.***

This table, the second of those designed to communicate information on the executives' outstanding equity interests, will reflect the number of shares acquired and the related value realized from the exercise of stock options or vesting of stock.

***The Pension Benefits Table.*** This is one of two tables on post-employment compensation. The table will be followed by a narrative description of material factors necessary to understand each plan disclosed in the table. The table will show the actuarial present value of each named executive officer's accumulated benefit under each pension plan, computed using the same assumptions (except for retirement age) and measurement period used for financial-reporting purposes. Companies will determine such amounts using current compensation levels and assuming the executive retires at normal retirement age under the plan. The valuation method and all material assumptions used will be described in the narrative section accompanying the table or by referring to the same disclosure in the financial statements or MD&A.

***The Nonqualified Deferred Compensation Table.***

This table, the other of the set on post-employment compensation, will display, with respect to deferred compensation plans that are not tax-qualified, executive contributions, company contributions, earnings (not just the above-market or preferential portion), withdrawals or distributions for the last fiscal year, and the year-end balance.

***Other Potential Post-Employment Payments Narrative.*** In addition to the set of tables on

post-employment compensation, the required disclosures will include a narrative description of any arrangement that provides for payments or benefits at, following, or in connection with any termination of a named executive officer, a change in responsibilities, or a change in control of the company. A company will be required to quantify these potential payments and benefits as if the triggering event took place on the last business day of the company's latest fiscal year and the price per share was the closing market price on that date. In the event of uncertainties about the benefits or the amounts involved, the company is required to make a reasonable estimate (or range of estimates) and disclose material assumptions underlying the estimates. The disclosure may be considered forward-looking information subject to related safe harbors.

**Director Compensation.** Compensation provided to each director in the last fiscal year will be presented in a compensation table similar to the Summary Compensation Table and will be supplemented with a narrative discussion of the elements of directors' compensation.

#### **Relationship to the Financial Statements.**

The compensation disclosures will not necessarily be identical to related amounts in the financial statements. For example, the total grant-date fair value for stock-based compensation will be shown in the Summary Compensation Table as compensation in the year the grant is made. Under Statement 123R, the amount for equity-classified awards is generally recognized in the financial statements over the period during which the employee provides service in exchange for the award (typically, the vesting period), and liability-classified awards are initially measured at grant-date fair value and remeasured to fair value in the financial statements at each subsequent reporting date. The remea-

surement will not be reflected in the new executive compensation disclosure.

The grant-date fair value should be calculated using the same reasonable groupings of individuals for purposes of determining the expected-term assumptions required by Statement 123R. If a company uses more than one group, the table disclosure should be based on the group that includes the named executive officers or directors.

The increase in pension value included in the compensation disclosures is based on the present value of accumulated benefits determined as of the same measurement date as is used in the audited financial statements. A company should use the same assumptions that it applies when computing its accumulated benefit obligation under Statement 87, but should modify that calculation by assuming the retirement age is the normal retirement age defined in the plan (or the earliest time at which a participant may retire under the plan without any benefit reduction due to age).<sup>3</sup> Under current accounting rules, pension obligations and net periodic pension cost are measured using the projected benefit obligation, and the accumulated benefit obligation is disclosed. The principle difference between these two amounts is that the projected benefit obligation includes expectations about future salary increases, whereas the accumulated benefit obligation does not.

#### **Re-exposure of Proposal on Additional**

**Highly Compensated Employees.** The SEC decided to request additional comment on its proposal to require compensation disclosure for up to three additional highly compensated employees. The request focuses on the SEC's intention to limit these disclosures to individuals who have responsibility for significant policy decisions. Comments are due 45 days after publication in the Federal Register.

## **Equity Ownership of Officers and Directors**

In addition to a table reporting the number of shares of company stock beneficially owned by named executive officers, directors, and director nominees, including qualifying shares, companies must disclose the number of shares of company stock, if any, those individuals have pledged as collateral.

## **Related-Person Transactions**

The rules add to the requirements for disclosures about related-person transactions. Registrants will be required to disclose information about their policies and procedures for approving related-person transactions; the categories of related persons are slightly expanded; and the threshold for disclosure under Item 404(a) of Regulation S-K is changed from \$60,000 to \$120,000.

## **Director Independence and Corporate Governance**

The rules create new Item 407 of Regulations S-K and S-B, which requires specified disclosures about directors. The new Item is intended to align the SEC's disclosure requirements with those of the New York Stock Exchange and Nasdaq. The disclosures include those below:

- Whether each director and director nominee is independent,
- Any relationships by specific category or type not otherwise disclosed that were considered in determining whether each director and director nominee is independent,
- Any audit, nominating, and compensation committee members who are not independent, and
- Whether the compensation committee has a charter and a description of the processes and procedures for considering executive and director compensation.

Item 407 consolidates several corporate-governance disclosure requirements from the

<sup>3</sup> FASB Statement No. 87, *Employers' Accounting for Pensions*, December 1985, available at [www.fasb.org](http://www.fasb.org).



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proxy rules and Regulations S-K and S-B. They include requirements to disclose matters pertaining to board meetings and committees, other specifics about nominating and audit committees, and similar disclosures regarding compensation committees.

#### Form 8-K

The rules consolidate all Form 8-K disclosures about employment arrangements under a single item. They also modify the disclosure requirements in Form 8-K to require companies to disclose specified employment arrangements for named executive officers and material amendments to the arrangements.

#### Effective Date and Transition

The effective dates for compliance with the new rules are given below for the affected filing forms:

- Form 8-K: Triggering events that occur after 59 days from the date the rules are published in the Federal Register.
- Forms 10-K and 10-KSB: Fiscal years ending on or after December 15, 2006.
- Proxy or information statements and Securities Act and Exchange Act registration statements (including pre- and post-effective amendments) covering registrants (other than registered investment companies) that are required to include Item 402 and 404 disclosures for fiscal years ending on or after December 15, 2006.
- Initial registration statements and post-effective amendments that are annual updates to effective registration statements that are filed on Forms N-1A, N-2, and N-3 (except those filed by business development companies): On or after December 15, 2006.
- Proxy and information statements covering registered investment companies: On or after December 15, 2006.

Companies will not be required to restate information on executive compensation and related-person transactions for prior years that was previously disclosed in accordance with then current rules. This means, for example, that only the most recent fiscal year will have to be reflected in the revised Summary Compensation Table when the requirement for that table becomes effective. The information for years prior to the most recent fiscal year will not have to be presented at all. This transition approach will phase in the use of the Summary Compensation Table and disclosure under amended Item 404(a) over a three-year period for Regulation S-K companies. During this phase-in period, companies will not be required to present prior years' compensation or disclosure or Item 404(a) disclosure under the former rules.

Registrants should not treat the descriptive and summary statements in this article as a substitute for the text of the SEC rule or any other related rules and proposals. When subsequently complying with related filing requirements, registrants should consult the text of the final rule, consider their particular circumstances, and consult their accounting and legal advisors.