



SEC Proposes Revised Executive Compensation Disclosures

Companies will be reporting more data on executive compensation in their 2007 proxy materials, including figures for total annual compensation, if a new proposal published by the SEC is adopted as exposed for public comment.¹ The proposal would also revise the guidance on identifying perquisites and the disclosure requirements for related-party transactions, director compensation, officers' and directors' security ownership, director independence, and other specifics of corporate governance. The rules would affect disclosure in proxy statements, annual reports, registration statements, and Form 8-K reports.

This edition of *Defining Issues* summarizes the main features of the proposal for companies that are not subject to the SEC's rules and regulations covering small business issuers. The proposed requirements for issuers subject to Regulation S-B call for less extensive disclosure. The potential effect of the proposed rules on compliance obligations is a legal matter on which companies should consult their securities counsel.

Executive Compensation

The proposal would redefine the individuals for whom compensation must be disclosed, require that a total compensation amount and its components be disclosed for each of those individuals, and mandate an explanation of the key determinants of the company's compensation decisions. The information would be presented in new and modified formats.

Compensation disclosures would be required for the company's chief executive and financial officers and the three other highest-paid executive officers, these five being designated the "Named Executive Officers." The proposed rules would also add a requirement to disclose the total compensation and job description 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.

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¹ SEC Release No. 33-8655, *Executive Compensation and Related Party Disclosure*, January 27, 2006, available at www.sec.gov/rules/proposed/33-8655.pdf.

A new narrative Compensation Discussion and Analysis section would be used to disclose the most important factors that determine the company's executive compensation policies and decisions. This section is intended to set the context for the tabular material that follows it. The presentation would include the company's compensation objectives, how its compensation program is designed to reward executives, 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 proposed Compensation Discussion and Analysis section would be filed with the SEC. The filing would be subject to liability under the Exchange Act and subject to certification by the company's Chief Executive and Chief Financial Officers.

Like other features of the proposal, the Compensation Discussion and Analysis section would be required to be presented in plain English. The section would replace the Board Compensation Committee Report on Executive Compensation and the five-year stock price performance graph.

Revised tables containing compensation figures would cover three broad categories: total compensation over the last three years, outstanding equity-related interests received as compensation that are the source of future gains, and retirement plans and other post-employment payments and benefits.

The Summary Compensation Table. This reorganized table would present the following

information for each named executive officer for each of the prior three years:

- The person's total aggregate compensation.
- Annual salary and bonus (data already required to be disclosed) in separate columns.
- Stock and option awards granted or modified during the year shown in separate columns at their total grant-date fair value or total fair value at the modification date, as computed according to Statement 123R's requirements.² Stock awards include stock-related awards that do not have option-like features, but nevertheless 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 would disclose all assumptions made in valuing these awards by referring to the discussion of the assumptions in the

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

- The monetary value of all earnings from performance-based compensation arrangements that are not equity-based arrangements.
- All other compensation not already subject to disclosure under the requirements just described, for example: an aggregate increase in the actuarial value of pension plans accrued during the year, company contributions to defined-contribution pension plans during the year and earnings on the plans, earnings during the year on non-qualified deferred compensation, tax reimbursements, life insurance premiums, and perquisites and personal benefits. Each of these elements of compensation, with the exception of perquisites and personal benefits, would have to be identified and quantified in a footnote if its amount is \$10,000 or more. Perquisites and personal benefits would have to be identified in a footnote if their aggregate value is \$10,000 or more and would be individually quantified if their value exceeds \$25,000 or 10

Identifying Perquisites

According to the proposal, a perquisite confers a direct or indirect benefit that has a personal aspect and is neither generally available to all employees on a non-discriminatory basis nor integrally and directly related to the performance of the executive's duty. A benefit provided to the executive for a business reason or for the convenience of the company may be a perquisite if that benefit is not integrally and directly related to the performance of the executive's duty. The proposal would require a perquisite to be measured at its incremental cost to the company.

The proposed rule includes examples of benefits that the SEC staff believes are perquisites. Registrants should consult with legal counsel about the relationship between their disclosure obligations in this year's proxy season and the SEC proposal's examples and other interpretive guidance.

² FASB Statement 123 (revised 2004), Share-Based Payment, December 2004, available at www.fasb.org.

percent of total perquisites and personal benefits. The current threshold for disclosing perquisites is \$50,000 or 10 percent of total annual salary and bonuses. The proposed rules include guidance for determining what constitutes a perquisite.

If the receipt of any compensation that is currently payable has been deferred for any reason, the amount deferred would have to be disclosed in a footnote to the applicable column.

The Grants of Performance-Based Awards Table. This table would supplement the Summary Compensation Table by disclosing all grants of performance-based awards to the executives, whether or not they are share-based. Among the disclosures proposed for this table are the grant-date fair value of stock awards, the annual amounts earned under non-stock-based awards and the terms of each grant made during the year, including an estimate of future payouts. For purposes of this table, performance-based awards are awards that are subject to either a performance or market condition, as those terms are defined in Statement 123R.

The Grants of All Other Equity Awards Table. Also a supplement to the Summary Compensation Table, this table would disclose all equity-based awards granted in the last fiscal year that are not performance-based.

Narrative Disclosure to Summary Compensation Table and Supplemental Tables. Following the Summary Compensation Table and supplemental tables just described, would be a narrative description of any additional material factors necessary to understand the information disclosed in those tables. Material factors to be disclosed in this sec-

tion will vary, but may include material terms in the named executive officers' employment agreements, a description of any modification to an outstanding stock-based compensation award, a description of performance-based conditions applicable to an award, or material assumptions underlying the actuarial values of defined-benefit plans.

The Outstanding Equity Awards at Fiscal Year End Table. This is one of two tables designed to communicate disclosures on the executives' outstanding equity interests. It would show details of equity awards that remain unexercised or unvested, including the market-based value of the awards as of the company's most recent fiscal year-end.

The Option Exercises and Stock Vested Table. This table, the second of those designed to communicate disclosures on the executives' outstanding equity interests, would compare amounts realized from the exercise of stock options or vesting of stock to the award's grant-date fair value reported in the Summary Compensation Table.

The Retirement Plan Potential Annual Payments and Benefits Table. This is one of two proposed tables on retirement and other post-employment benefits. It would show the annual benefits payable under each defined-benefit plan to each named executive officer at the normal retirement age and, if available, at an early retirement age. The table would be followed by a narrative description of material factors necessary to understand each plan disclosed in the table.

The Nonqualified Defined Contribution and Other Deferred Compensation Plans Table. This table, another of the set on retirement and other post-employment benefits, would

display annual executive contributions, company contributions, earnings, withdrawals, and the year-end balance under deferred compensation plans that are not tax-qualified.

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, including repricings and other modifications of awards that are treated as new awards, would be shown in the proposed disclosures as compensation in the year the grant is made. Under Statement 123R, the amount 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).

Director Compensation

Compensation provided to each director in the last fiscal year would be presented in a compensation table similar to the Summary Compensation Table that would be used to disclose executives' compensation, along with a narrative discussion of the elements of directors' compensation.

Security Ownership

The proposal would require that the table reporting the number of shares of company stock that executives and directors beneficially own also disclose the number of shares, if any, pledged as collateral by management.

Related-Party Transactions

The proposed rules would add to the requirements for disclosures on related-party transactions. Registrants would have to disclose information about their policies and procedures for approving related-party transactions; the categories of related parties would be



slightly expanded; and the threshold for disclosure under Item 404(a) of Regulation S-K would be changed from \$60,000 to \$120,000.

Corporate Governance

The proposal would create new Item 407 of Regulation S-K, which would require three disclosures about directors:

- Whether each director and director nominee is independent,
- A description of any relationships not otherwise disclosed that were considered when determining whether each director and director nominee is independent, and
- Any audit, nominating, and compensation committee members who are not independent.

Item 407 would also consolidate several corporate-governance disclosure requirements from the proxy rules and Regulation S-K. They include requirements to disclose matters pertaining to board meetings and committees, specifics about nominating and audit committees, similar disclosures regarding compensation committees, and a narrative description of compensation committees' procedures for determining executive and director compensation.

Foreign Private Issuers

Foreign private issuers would be permitted to continue to follow the compensation disclosure requirements contained in Form 20-F. A foreign filer would provide more detailed information if it makes the information publicly available for some other reason (e.g., a home-country reporting requirement).

Form 8-K

The proposal would consolidate all Form 8-K disclosures regarding employment arrangements under a single item. It would 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.



Comments on the proposed rules are due April 10, 2006. The final rules are not expected to be adopted in time for the 2006 proxy season, but likely would apply to disclosures of 2006 compensation that are made during the 2007 proxy season.

Registrants should not treat the descriptive and summary statements in this presentation as a substitute for the text of the SEC proposal, the as yet unpublished 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.

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