

Heads Up

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Show Me the Money!

SEC Finalizes Disclosure Requirements for Executive Compensation

by Deloitte & Touche LLP's Accounting Standards and Communications Group and SEC Services Group

Update: After this *Heads Up* was issued, the SEC amended the disclosure requirements discussed below. The amendments change the compensation expense for stock option grants that is reported in the primary disclosure tables (the Summary Compensation Table for executive officers and the Director Compensation table for directors). Originally, the disclosures in these tables were required to reflect the full grant date fair value of the awards. Under the amendments, the disclosures more closely align with the expense recorded in the financial statements under FASB Statement No. 123(R), *Share-Based Payment*. For more information on these changes, see Deloitte & Touche LLP's January 8, 2007, *Heads Up*.

On July 26, 2006, after receiving more than 20,000 comment letters on its proposal, the Securities and Exchange Commission (SEC) adopted amendments to the disclosure requirements for executive and director compensation and other related matters. In Chairman Christopher Cox's opening statement at the meeting adopting the new rules, he stated that the new disclosures are designed to "clarify **executive pay**; demystify any **financial dealings** between executives and the companies they work for (what we call related party transactions); and shed welcome new light on the degree of **director independence** and the quality of corporate governance at our nation's public companies." Chairman Cox's remarks also indicate that recent developments regarding stock options have influenced the required disclosures. He noted that the revised disclosures include "a thoroughly modernized presentation of stock option compensation that includes strong new protections against **undisclosed backdating** or **spring loading** of options."

Why were the changes necessary? The SEC has revisited disclosure requirements several times over the years due to changing trends in executive compensation. For example, in 1983 the SEC adopted a primarily narrative approach. In 1992 the SEC switched to a highly formatted, tabular approach that categorized the elements of compensation to allow easier comparison between years and companies. In the past few years, investors have been paying greater attention to executive and director compensation. In addition to this increased attention, the SEC had concerns that the rigid format of the tables led some to believe that if certain methods of compensation did not fit into a category, they did not have to be disclosed. The tables also did not

specifically require a single figure for total compensation, and thus a total was generally not provided. Additionally, without a narrative description of items included in a particular category, the various elements of compensation may be unclear.

The amendments attempt to address these concerns and can be categorized as follows:

- Officers and Directors Covered
- Compensation Discussion and Analysis
- Compensation Tables
- Other Changes

The following paragraphs summarize the significant components of the disclosure requirements. Examples of the required tables are included in the [Appendix](#).

Officers and Directors Covered

The final rule¹ requires disclosure of the compensation of the principal executive officer, the principal financial officer, and up to three other most highly compensated executive officers. Prior to the amendments, the principal financial officer was not specifically required to be disclosed unless the principal financial officer was among the next four highest paid officers. The three most highly compensated executive officers are determined based on total compensation (less above-market or preferential earnings on nonqualified deferred compensation plans and the increase in pension values). Collectively, these individuals are referred to as the “named executive officers.” In addition, the compensation disclosure requirements for directors have been expanded and now all compensation to each director must be disclosed in a separate summary compensation table.

The original proposal included compensation disclosures for up to three additional most highly compensated employees who were not executive officers or directors, but who earned more than the named executive officers. That disclosure was not adopted on July 26, and the SEC is soliciting additional comments in this area. For more details see the “Request for Comments” section below.

Compensation Discussion and Analysis

The Compensation Discussion and Analysis section is similar in concept and design to the narrative disclosures in the Management’s Discussion and Analysis section of companies’ periodic reports. It is meant to provide general information on the material factors underlying compensation policies and decisions reflected in the data presented in the compensation tables. It is a principles-based requirement in that it identifies the disclosure concept and provides several examples. It is also a filed company document, as the SEC believes “it is appropriate for companies to take responsibility for disclosure.” The significant questions that the discussion should answer include:

- What are the objectives of the company’s compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How does each element and the company’s decisions regarding that element fit into the company’s overall compensation objectives and affect decisions regarding other elements?

The final rule provides examples of potential issues that companies may address, but the SEC states that companies should avoid boilerplate language and should tailor the disclosure to their specific policies. A company’s policies, programs, and practices regarding the awarding of stock options should also be discussed in this section. Potential stock option policies to cover include the selection of grant dates and the determination of exercise prices.

¹ Final Rule, *Executive Compensation and Related Person Disclosure* (August 11, 2006), available at www.sec.gov.

A company is required to disclose if it has or intends to have:

- a plan or practice of setting the exercise price of stock options at other than the market price at the grant date (such a plan/practice also should be disclosed in the Grants of Plan-Based Awards table; see discussion below), and/or
- a plan or practice to select option grant dates for executive officers in coordination with the release of non-public information.

In addition, a Compensation Committee Report, similar to the currently required Audit Committee Report, will be presented along with the Compensation Discussion and Analysis. The Compensation Committee Report will only be required one time during any fiscal year, and it will be furnished rather than filed. The CEO and CFO may look to the Compensation Committee Report in certifying the company's financial statements and disclosures.

Compensation Tables

The compensation tables reflect the compensation of the named executive officers and are reorganized and grouped into three broad categories:

- A Summary Compensation Table that presents compensation paid currently or deferred (including options, restricted stock, and similar grants) and compensation consisting of current earnings or awards that are part of a plan. Certain data in the Summary Compensation Table will be supplemented by additional tabular data.
- Holdings of equity-related interests that relate to compensation or are potential sources of future gains, with a focus on compensation-related equity interests that were awarded in prior years and are "at risk." This category includes three potential tables: a Grants of Plan-Based Awards table, an Outstanding Equity Awards at Fiscal Year-End table; and an Option Exercises and Stock Vested table.
- Retirement and other post-employment compensation, including retirement and deferred compensation plans, other retirement benefits, and other post-employment benefits. This category includes a Pension Benefits table and a Nonqualified Deferred Compensation table.

A Director Compensation table is required for all directors. It is substantially the same as the Summary Compensation Table, although the disclosure requirement is for only the most recently completed fiscal year. Directors may be disclosed as a group if their compensation is identical. Otherwise, each director must be listed separately.

Summary Compensation Table

A significant addition to existing rules is a requirement to present a total compensation column in the Summary Compensation Table. A further change is that the rules specifically state that any compensation that is not required to be included in another column in the Summary Compensation Table must be reported in the "All Other Compensation" column (e.g., perquisites and other personal benefits if the total is \$10,000 or greater, tax reimbursements, etc.). In addition to the tabular disclosure for each of the categories, the final rules require narrative disclosure sufficient to understand the information in the tables. For example, material terms in an executive officer's employment agreement or a repricing or other modification of outstanding options might need to be discussed. The disclosure retains the existing requirement to present the last three completed fiscal years.

Grants of Plan-Based Awards Table

This disclosure consists of one combined table that presents performance-based and non-performance-based grants. The following are required in the table:

- Disclosure of the grant date, as determined under Statement 123(R)².
- If the exercise price is less than the closing market price on the date of the grant, a column must be added to this table showing the market price on the date of the grant.

² FASB Statement No. 123(R), *Shared-Based Payment*.

- If the exercise price differs from the closing market price on the grant date, a description of the methodology for determining the exercise price is required.
- If the grant date is different from the date on which the compensation committee or full board of directors takes action to grant an option, a column must be added to this table showing the date the compensation committee or full board of directors took action.

The Grants of Plan-Based Awards table is supplemented with an Outstanding Equity Awards at Fiscal Year-End table and Option Exercises and Stock Vested table to provide additional information on these instruments as of the company's most recent fiscal year end.

Retirement and Other Post-Employment Compensation

The rule requires the disclosure of retirement benefits in a Pension Benefit table and a Nonqualified Deferred Compensation table, both of which are supported by a narrative discussion of any material factors. The Pension Benefit table includes the disclosure of the present value of the accumulated benefit for named executive officers. Additionally, the specific terms of termination provisions, written and unwritten, are required to be disclosed in narrative form, including the assumptions used in the calculations. This requirement includes potential payments in connection with a resignation, severance, retirement, or a change in control.

Other Changes

The final rule clarifies compensation arrangements required to be disclosed on Form 8-K and also amends the disclosure requirements for beneficial ownership, related party transactions, director independence, and board committee functions. Highlights of these new disclosures include:

- A narrative explanation of the independence status of directors under a company's director independence policies;
- New disclosure of a company's policies and procedures for review, approval, or ratification of related person transactions; and
- A requirement to disclose shares pledged by named executive officers, directors, and director nominees, and to disclose directors' qualifying shares.
- A requirement to disclose any compensation consultant and the consultant's role in determining or recommending pay.

Plain English

The final rule requires companies to use plain English principles in organization, language, and design.

Effective Dates

The new requirements will be effective in Form 8-K for triggering events that occur on or after 60 days after the new rule's publication in the Federal Register, in Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006, and in initial registration and proxy/information statements filed on or after December 15, 2006.

Only the most recent fiscal year information will be reflected in the Summary Compensation Table when the new rules become effective. Therefore, companies will not be required to "restate" prior-year disclosures.

Oh, What a Relief It Is!

SEC Proposes Extension of Section 404 Compliance Deadlines for Smaller Public Companies and Finalizes Extension for Certain Foreign Private Issuers

by Deloitte & Touche LLP's Accounting Standards and Communications Group and Assurance Services Group

In May of this year, the SEC and the Public Company Accounting Oversight Board (PCAOB) announced a series of plans to **improve the implementation** of Section 404 of the Sarbanes-Oxley Act of 2002. One such plan called for extending the compliance date of internal control reporting requirements for smaller public companies. In a continuation of this effort, on August 9 the SEC issued a release proposing an extension for **non-accelerated filers**. Under the extension, management's report assessing the effectiveness of a company's internal control over financial reporting is not required until fiscal years ending on or after December 15, 2007. The release proposes an extension of an additional year for the related auditor's attestation. Why the need for the extensions? Among the many reasons the SEC cites in the release are:

- To give management of non-accelerated filers time to apply COSO's³ "[Internal Control Over Financial Reporting — Guidance for Smaller Public Companies](#)," which was issued on July 11, 2006. The guidance describes a variety of approaches that smaller companies can use to apply the principles associated with the five key components of internal control over financial reporting and includes examples of how smaller companies might apply those principles.
- To provide time for the SEC to issue guidance on how management might perform a risk-based and scalable assessment of the effectiveness of internal control over financial reporting. On July 11, 2006, the SEC issued a [Concept Release](#) to seek public comment on the issues it should address in such guidance. The SEC has also indicated that to the extent it has not finalized such guidance in time to be of assistance for annual reports ending on or after December 15, 2007, it may propose further delays for compliance with the requirements of Section 404 for non-accelerated filers.
- To provide management of non-accelerated filers and their auditors the benefit of the anticipated changes that the PCAOB makes to Auditing Standard 2,⁴ as well as any implementation guidance that the PCAOB issues for auditors of smaller public companies. If the PCAOB does not finalize and the SEC does not approve revisions to Auditing Standard 2 in time to be of assistance with auditor attestation reports on management assessments for years ending on or after December 15, 2008, the SEC indicates that it will consider further postponing the auditor attestation report compliance dates for non-accelerated filers.
- To allow non-accelerated filers more time to prepare for full compliance in the most efficient manner. Also to save potential costs associated with the initial auditor's attestation and report on management's assessment during the period the SEC and PCAOB are developing the guidance referred to above and finalizing and implementing changes to Auditing Standard 2.

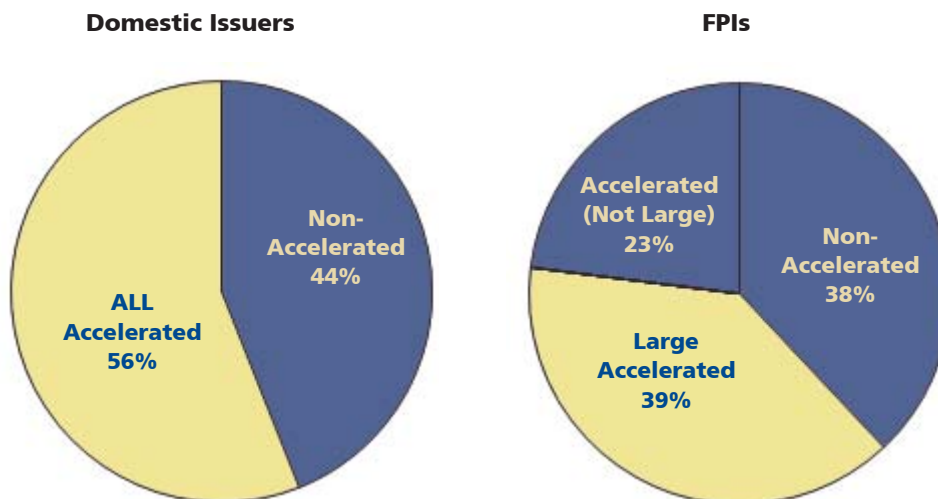
In addition, the release proposes a permanent transition period for Section 404 compliance for any newly public company, whereby such companies would not have to comply until their second annual report filed with the SEC. The SEC also issued a **final** release extending compliance for the auditor's attestation for foreign private issuers (FPIs) that are accelerated filers (but not large accelerated filers⁵).

³ The Committee of Sponsoring Organizations of the Treadway Commission.

⁴ PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*.

⁵ Among other criteria, large accelerated filers have a public float of \$700 million or more as of the last day of their most recently completed second fiscal quarter.

As shown in the diagrams below, the two releases affect a large number of public companies (indicated in blue). The proposed release extending the compliance deadline for non-accelerated filers indicates that it would affect over 40 percent of all domestic issuers and more than 35 percent of FPIs. The final release extending the auditor attestation compliance deadline for accelerated (not large) FPIs indicates that over 20 percent of FPIs will qualify. Therefore, over 60 percent of FPIs would receive a measure of relief.



Additional details on the proposed and final releases are set forth below.

Proposed Rule, Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies

The following table describes the differences between the existing and proposed compliance dates pursuant to the proposed rule.

Existing and Proposed Section 404 Compliance Dates				
Filer Status	Management’s Assessment — 404(a)		Auditor Attestation — 404(b)	
	Existing	Proposed	Existing	Proposed
Non-accelerated filer (domestic and foreign)	Fiscal years ending on or after July 15, 2007	Fiscal years ending on or after December 15, 2007	Fiscal years ending on or after July 15, 2007	Fiscal years ending on or after December 15, 2008

The proposals are as follows:

1. **Proposed Relief From Section 404 Compliance Dates for Smaller Companies**

The release proposes to extend the date by which non-accelerated filers must provide management’s report assessing the effectiveness of the company’s internal control over financial reporting from fiscal years ending on or after July 15, 2007, to fiscal years ending on or after December 15, 2007. In addition, the release proposes to extend the effective date for the auditor’s attestation report on internal control over financial reporting to the first annual report for a fiscal year ending on or after December 15, 2008.

Because of the different compliance dates for management’s assessment and the auditor attestation, the SEC has expressed a concern that a company’s assessment on year one could be questioned in year two if the auditor comes to a contrary conclusion in the second year. To address this concern, the release proposes that the management report included in the non-accelerated filer’s annual report during the first year of compliance be deemed “furnished” rather than “filed.” Similar relief is proposed for FPIs that are accelerated filers (but not large accelerated filers).

2. **Proposed Transition Relief for Newly Public Companies**

The release also proposes a transition period for Section 404 compliance for all newly public companies (i.e., any company that has become public through an IPO or a registered exchange offer, or that otherwise becomes subject to the Exchange Act reporting requirements, including an FPI that is listing on a U.S. exchange for the first time). Under the proposed rule, a newly public company, regardless of its size, will not be required to provide either a management assessment of internal control over financial reporting or an auditor attestation report thereon until it files its second annual report with the SEC.

Final Rule, Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Foreign Private Issuers That Are Accelerated Filers

The following table describes the differences between the existing and proposed compliance dates pursuant to the [final rule](#).

Existing and Proposed Section 404 Compliance Dates				
Filer Status	Management's Assessment — 404(a)		Auditor Attestation — 404(b)	
	Existing	Proposed	Existing	Proposed
FPI accelerated filer (not large)	Fiscal years ending on or after July 15, 2006	Fiscal years ending on or after July 15, 2006	Fiscal years ending on or after July 15, 2006	Fiscal years ending on or after July 15, 2007
Large FPI accelerated filer	Fiscal years ending on or after July 15, 2006		Fiscal years ending on or after July 15, 2006	

The final rule grants relief from Section 404(b) compliance for FPIs that are accelerated filers (but not large accelerated filers) and that file their annual reports on Form 20-F or 40-F. Accordingly, for such issuers the compliance date for providing an auditor's attestation report on internal control over financial reporting in their annual reports is extended for an additional year, to fiscal years ending on or after July 15, 2007. However, management's report is still required for fiscal years ending on or after July 15, 2006. The release does not change the current requirements for compliance with Section 404 for large accelerated FPIs, which is for fiscal years ending on or after July 15, 2006.

This rule was immediately made final because, due to the existing 2006 effective date, the SEC felt that submitting the rule through the proposal process would reduce the likelihood of companies deriving any meaningful benefit from an extension granted any later in the year. However, concurrent with the issuance of the proposed rule mentioned above, the SEC did provide for comments to be made on any additional relief or guidance that should be considered for FPIs.

Next Steps

Comments on the proposed release extending the compliance deadlines for non-accelerated filers should be submitted to the SEC on or before September 14, 2006. In addition, the SEC is seeking feedback on its Concept Release on management's assessment. All issuers are strongly encouraged to take advantage of the opportunity to provide their input to the SEC on the Concept Release. Comments are due on or before September 18, 2006.

The press release and SEC releases, as well as the instructions and contact information for comments, are available on the [SEC's Web site](#).

Appendix: Tables Required by Executive Compensation Rule

The following tables are required under the rules adopted by the SEC in its final rule release.

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 ⁶	_____								

PFO ⁷	_____								

A	_____								

B	_____								

C	_____								

⁶ "PEO" refers to principal executive officer. See Section II.C.6.a. in the final rule for a description of the proposed named executive officers for whom compensation disclosure is required.

⁷ "PFO" refers to principal financial officer.

Grants of Plan-Based Awards

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards (\$/Sh)
		Threshold (\$)	Target (\$)	Maximum (\$)	Threshold (#)	Target (#)	Maximum (#)			
PEO										
PFO										
A										
B										
C										

Outstanding Equity Awards at Fiscal Year End

Name	Option Awards					Stock Awards			
	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#)	Option Exercise Price (\$)	Option Expiration Date	Number of Shares or Units of Stock That Have Not Vested (#)	Market Value of Shares or Units of Stock That Have Not Vested (\$)	Equity Incentive Plan Awards: Number of Shares, Units or Other Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested (\$)
PEO									
PFO									
A									
B									
C									

Option Exercises and Stock Vested

Name	Option Awards		Stock Awards	
	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise (\$)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting (\$)
PEO				
PFO				
A				
B				
C				

Pension Benefits

Name	Plan Name	Number of Years Credited Service (#)	Present Value of Accumulated Benefit (\$)	Payments During Last Fiscal Year (\$)
PEO				
PFO				
A				
B				
C				

Nonqualified Deferred Compensation

Name	Executive Contributions in Last FY (\$)	Registrant Contributions in Last FY (\$)	Aggregate Earnings in Last FY (\$)	Aggregate Withdrawals/Distributions (\$)	Aggregate Balance at Last FYE (\$)
PEO					
PFO					
A					
B					
C					

Director Compensation

Name	Fees Earned or Paid in Cash (\$)	Stock Awards (\$)	Option Awards (\$)	Non-Equity Incentive Plan Compensation (\$)	Change in Pension Value and Nonqualified Deferred Compensation Earnings (\$)	All Other Compensation (\$)	Total (\$)
A							
B							
C							
D							
E							

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On September 8 at 2:00 PM EDT, we will host a 60-minute webcast, "What Do the New SEC Rules on Executive Compensation Mean for Your Company?" [Register](#) for this webcast today. Also, on September 13 at 2:00 p.m. EDT, we will host a 90-minute webcast, "EITF Roundup: Highlights of the September Meeting." [Registration](#) is also available for this webcast.

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