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SEC Issues Final Rule Related to Pay Versus Performance

by Edward Sim and Ian Dawson, Deloitte Tax LLP, and Katy Rossino and Doug Rand, Deloitte & Touche LLP

Background

On August 25, 2022, the SEC issued a final rule[1] that requires certain registrants to provide disclosures about executive pay and company performance within any proxy statement or information statement for which executive compensation disclosures are required. According to SEC Chair Gary Gensler, the final rule, which adds Item 402(v) to SEC Regulation S-K, is intended to "help investors receive the consistent, comparable, and decision-useful information they need to evaluate executive compensation policies. That serves investors and our markets."

The final rule implements a mandate under the Dodd-Frank Act[2] that requires a registrant to disclose the relationship between executive compensation actually paid and the financial performance of the registrant. It also reflects public comment on the SEC's April 2015 proposed rule, which was reopened for comment in January 2022. Under the final rule, both prescribed and free-form disclosures are required for the registrant's principal executive officer (PEO) as well as other named executive officers (NEOs) besides the PEO (see details below). The disclosure requirements are effective for registrants beginning with fiscal years ending on or after December 16, 2022, and apply to all registrants other than emerging growth companies (EGCs), registered investment companies, and foreign private issuers. Smaller reporting companies (SRCs) are exempt from certain of the requirements.

[1] SEC Final Rule Release No. 34-95607, *Pay Versus Performance*.

[2] The final rule implements 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.

The Tabular Disclosure Requirement

Under the final rule, a registrant must disclose several pay and performance calculations in a tabular format as follows:

					Value of Initial Fixed $100 Investment Based On:			
Year (a)	Summary Compensation Table Total for PEO (b)	Compensation Actually Paid to PEO (c)	Average Summary Compensation Table Total for Non-PEO NEOs (d)	Average Compensation Actually Paid to Non-PEO NEOs (e)	Total Shareholder Return (f)	Peer Group Total Shareholder Return* (g)	Net Income (h)	[Company-Selected Measure]* (i)
Y1								
Y2								
Y3								
Y4*								
Y5*								

The rows and columns marked with an asterisk (*) are not required for SRCs.

While the table looks relatively straightforward, registrants must consider several important details. Below we break down each component of the table and explain in detail what is required.

Column Reference	Column Name	Requirements
(a)	Year	• Reflects information for the five most recently completed fiscal years (three for SRCs), subject to transition provisions.
(b)	Summary Compensation Table Total for PEO	• Calculate total compensation in accordance with Regulation S-K, Item 402(c)(2)(x) or Item 402(n)(2)(x) for SRCs (i.e., the Summary Compensation Table values under existing SEC executive compensation disclosure requirements). • In years in which there are multiple PEOs, add an additional column or columns to reflect each PEO individually.

(Table continued)

Column Reference	Column Name	Requirements
(c)	Compensation Actually Paid to PEO	• Calculate starting with the amount listed in column (b), subject to the following adjustments: *Adjustments Related to Defined Benefit and Actuarial Pension Plans* ◦ **Subtract** the "aggregate change in the actuarial present value of the . . . accumulated benefit under all defined benefit and actuarial pension plans reported in the Summary Compensation Table." ◦ **Add** actuarially determined service costs for services rendered during the fiscal year (i.e., GAAP service cost attributable to the NEO). ◦ **Add** prior services costs — the "entire cost of benefits granted (or credit for benefits reduced) in a plan amendment (or initiation) during the covered fiscal year that are attributed by the benefit formula to services rendered in periods prior to the amendment," determined in accordance with U.S. GAAP. **Connecting the Dots** These adjustments are consistent with the concept of prior service costs outlined in ASC 715.[3] However, for financial statement purposes, the prior service costs may be deferred and systematically amortized into net periodic benefit cost over the expected remaining service period. Registrants would reflect the full prior service costs related to plan amendments during the fiscal year for this adjustment rather than the amount amortized. *Adjustments Related to Stock-Based Compensation* ◦ **Subtract** values reported in the Stock Awards and Option Awards columns of the Summary Compensation Table. ◦ For any equity awards granted in the covered fiscal year that are outstanding and unvested as of the end of the covered fiscal year, **add** the year-end fair value. ◦ For any awards granted in prior years that are outstanding and unvested as of the end of the covered fiscal year, **add** the increase (or **subtract** the decrease) in fair value by comparing the fair value at the end of the fiscal year with the fair value at the end of the prior fiscal year. ◦ For awards that are granted and vest in the same covered fiscal year, **add** the fair value as of the vesting date. ◦ For awards granted in prior years that vest in the covered fiscal year, **add** the increase (or **subtract** the decrease) in fair value by comparing the fair value on the vesting date with the fair value at the end of the prior fiscal year.

[3] FASB Accounting Standards Codification (ASC) Topic 715, *Compensation — Retirement Benefits*.

(Table continued)

<table>
<tr><th>Column Reference</th><th>Column Name</th><th>Requirements</th></tr>
<tr><td>(c) (continued)</td><td>Compensation Actually Paid to PEO (continued)</td><td>

For awards granted in prior years that are deemed to fail to meet the applicable vesting conditions during the covered fiscal year, subtract the fair value at the end of the prior fiscal year.
For any dividends or other earnings paid on stock or option awards in the covered fiscal year before the vesting date, add such amount if it is not otherwise reflected in the fair value of such award or included in any other component of total compensation for the covered fiscal year.
Registrants should also consider the following when determining adjustments related to stock-based compensation:

Adjustments must include any compensation attributable to amendments, cancellations, modifications, or replacements.
Fair value should be determined in a manner consistent with fair value applicable to share-based payments reflected in the registrant's financial statements.
For awards subject to performance conditions, registrants should calculate the changes in fair value on the basis of the probable outcome of the performance condition at the end of the fiscal year.
Updates to fair value determinations may be required each year, even if the financial statements reflect such awards only at their grant-date fair value.

Connecting the Dots
Diligent recordkeeping will be required for the equity portion of compensation actually paid. Companies would do well to quickly develop a process for accommodating and tracking changes in NEOs and all corresponding outstanding equity information. Year-end fair value calculations would need to be completed by using the same method the company uses for share-based payments reflected in the financial statements under GAAP. The example below illustrates these calculations.
</td></tr>
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(Table continued)

Column Reference	Column Name	Requirements
(c) (continued)	Compensation Actually Paid to PEO (continued)	**Example** Registrant A's fiscal year-end is December 31. On March 1, 20X2, A grants to its PEO 100 restricted stock units (RSUs) that will vest in two years. The grant date fair value, which will be included in the Summary Compensation Table for the year ended December 31, 20X2, is $500. On December 31, 20X2, the fair value of the unvested RSUs is $750. In calculating the amount for column (c) of the pay-versus-performance table for the year ended December 31, 20X2, A would deduct the $500 reflected in the Summary Compensation Table for the award and add $750, which represents the fair value of the outstanding and unvested award as of December 31, 20X2. On December 31, 20X3, the fair value of the unvested RSUs is $650. Since the award was granted in the prior year, no amounts are included in the Summary Compensation Table for the year ended December 31, 20X3. In calculating the amount for column (c) of the pay-versus-performance table for the year ended December 31, 20X3, A would subtract $100, which represents the decrease in the fair value of the outstanding and unvested award as of December 31, 20X3, compared with the fair value as of December 31, 20X2. On March 1, 20X4, the award vests and the fair value is $950 at the time of vesting. Since the award was granted in the prior year, no amounts are included in the Summary Compensation Table for the year ended December 31, 20X4. In calculating the amount for column (c) of the pay-versus-performance table for the year ended December 31, 20X4, A would add $300, which represents the increase in the fair value as of the vesting date compared with the fair value on December 31, 20X3.
(d)	Average Summary Compensation Table Total for Non-PEO NEOs	• Calculate average total compensation in accordance with Regulation S-K, Item 402(c)(2)(x) or Item 402(n)(2)(x) for SRCs (i.e., the Summary Compensation Table values under existing SEC executive compensation disclosure requirements), for the NEOs, excluding the PEO, in each fiscal year. • Note that new calculations of the five-year history on the basis of the latest fiscal-year-end NEOs would not be required, and different individuals may be included in the average throughout the five-year period. • Disclose in a footnote the list of individual NEOs whose compensation is represented in each year.

(Table continued)

Column Reference	Column Name	Requirements
(e)	Average Compensation Actually Paid to Non-PEO NEOs	• Determine amounts in a manner consistent with the instructions for column (c), by averaging the NEOs, excluding the PEO, in each fiscal year.
(f)	Value of Initial Fixed $100 Investment Based on: Total Shareholder Return	• Calculate this amount on the same cumulative basis as that used in preparing the performance graph required by Regulation S-K, Item 201(e). Measure from the market close on the last trading day before the registrant's earliest fiscal year in the table through and including the end of the fiscal year for which total shareholder return (TSR) is being calculated (i.e., the TSR for the first year in the table will represent the TSR over that first year, the TSR for the second year will represent the cumulative TSR over the first and the second years, and so forth).
(g)	Value of Initial Fixed $100 Investment Based on: Peer Group Shareholder Return	• See instructions for column (f) above. • Registrants may use either the peer group identified for the performance graph or, if applicable, a peer group used in the compensation discussion and analysis (CD&A) to disclose their compensation benchmarking practices. • The constituents of the peer group must be disclosed in a footnote unless the peer group is based on a published industry or line-of-business index. • Peer group TSR must be weighted on the basis of market capitalization at the beginning of each period. • If the peer group has changed, all values in the reported table should reflect the new peer group and a footnote must be added to explain the reason for change, and the registrant's TSR must be compared with both the new and old groups. • SRCs are not required to disclose this information.
(h)	Net Income	• This is GAAP net income.

(Table continued)

Column Reference	Column Name	Requirements
(i)	Company-Selected Measure	• The selected measure must be a financial performance measure, which is a measure that is "determined and presented in accordance with [GAAP,]" any measure that is "derived wholly or in part from such measures, and stock price and total shareholder return." • The measure must be part of the "Tabular List" (described in the next section). • The measure should represent the most important financial performance measure (other than net income or TSR) used by the registrant to link compensation for the most recent fiscal year to company performance. • Measures may include GAAP financial measures such as revenue, operating profit, or segment profit as well as non-GAAP financial measures such as EBITDA or adjusted net income. **Connecting the Dots** SEC Regulation G and Regulation S-K, Item 10(e), provide disclosure requirements related to non-GAAP measures, including a reconciliation to the most comparable GAAP measure. Since this disclosure is meant to aid in the analysis of compensation, the rule specifically exempts from the requirements of Regulation G and Item 10(e), a company-selected measure that is a non-GAAP measure. However, a registrant must disclose how the measure is calculated from its audited financial statements. This is consistent with the existing requirement in Instruction 5 to Regulation S-K, Item 402(b), under which performance targets disclosed in CD&A that are based on non-GAAP measures are similarly exempt from the more detailed disclosure requirements in Regulation G and Item 10(e) as long as a registrant describes how such targets are calculated. • A registrant may add more columns to present additional measures; however, "[a]ny supplemental measures of compensation or financial performance and other supplemental disclosures provided by registrants must be clearly identified as supplemental, not misleading, and not presented with greater prominence than the required disclosure." • SRCs are not required to disclose this information.

Other Disclosure Requirements

In addition to presenting tabular disclosures, a registrant must provide clear descriptions of the relationships between the following for the fiscal years presented:

- "Compensation Actually Paid to the PEO" (column c) and "Average Compensation Actually Paid to Non-PEO NEOs" (column e) and each of the registrant's (1) TSR (column f), (2) "Net Income" (column h), and (3) "Company-Selected Measure(s)" (column i).
- The registrant's TSR and peer-group TSR.

A registrant may describe relationships graphically, narratively, or by using a combination of both; the final rule gives them discretion to determine the best method for communicating compensation information to investors. If a registrant elects to present an additional supplemental measure, it must similarly discuss the relationship between compensation and that measure.

In addition, a non-SRC registrant must provide an unranked list (the "Tabular List") of three to seven of the most important measures it used to link (1) executive compensation actually paid to (2) company performance during the most recently completed fiscal year, as follows:

- If the registrant considers fewer than three financial performance measures when linking to compensation actually paid, it will only need to disclose the number of measures it considers. If it considers no financial performance measures, the Tabular List is not required.
- The Tabular List does not need to be ranked in order of importance.
- The measures may be nonfinancial performance measures (e.g., number of customers, shipments, or users or other operational measures) as long as there are also at least three financial measures included in the Tabular List.
- The registrant may present the Tabular List in any of the following manners:
    - One list that represents the most important performance measures related to compensation actually paid to all NEOs, including the PEO(s).
    - Two lists, one for non-PEO NEOs and one for PEOs. Each list must include three to seven measures.
    - One list for the PEO and one list for each NEO. Each list must include three to seven measures.

Connecting the Dots

The Tabular List should be based on the most important financial performance measures used to link compensation for the most recently completed fiscal year, not for all five years being disclosed. This gives registrants the flexibility to change measures as the strategy and objectives of the company change, along with compensation programs. Any changes to the measure(s) should be clearly explained.

Many registrants already disclose several measures that form the basis of their short- or long-term incentive compensation plans. This disclosure is likely to be a good starting point for consideration; however, the final rules do not require the Tabular List to be completely aligned to disclosures in CD&A. If seven or fewer measures are used among the various incentive plans, it is expected that all would need to be disclosed given their direct impact on executive compensation.

Location and Tagging

The final rule's requirements do not apply to registration statements or annual reports; they only apply to proxy statements and information statements for which executive compensation disclosures are required. A registrant is permitted to determine the best location within the proxy statement or information statement for the required disclosures. They do not have to be included in CD&A since some registrants may not consider pay versus performance in compensation decisions. Further, the final rule requires registrants to tag the information by using Inline XBRL.

Smaller Reporting Companies

Certain of the final rule's disclosure requirements do not apply to SRCs. Specifically, SRCs are:

- Only required to present three, instead of five, fiscal years of disclosure under new Regulation S-K, Item 402(v).
- Not required to disclose amounts related to pensions when providing executive compensation actually paid.
- Not required to present peer-group TSR, a company-selected measure, or the Tabular List.
- Permitted to provide two years of data, instead of three, in the first applicable filing after the final rule becomes effective.
- Only required to present the prescribed table in XBRL format beginning in the third filing in which they provide pay-versus-performance disclosures.

Newly Public Registrants

While the final rule's requirements do not apply to EGCs, they include transition provisions for newly public companies that are not EGCs. Because the disclosures are not required in registration statements, they do not have to be provided during the IPO process. Also, the requirements apply only for years in which a registrant was subject to reporting requirements under the Securities Exchange Act of 1934 (i.e., a public company). For example, if a non-EGC registrant completes its IPO in 2022, the proxy statement for fiscal year 2022 would provide disclosure for only fiscal year 2022. The registrant would add subsequent years to each annual proxy filing until it includes five years (i.e., in the proxy filing for fiscal year 2026, which would be the year that includes the fourth anniversary of its IPO).

Effective Date and Transition

The disclosure requirements are effective for companies beginning with fiscal years ending on or after December 16, 2022. Under the final rule's transition relief, a non-SRC registrant may provide the required tabular disclosure for "three years, instead of five years, in the first filing in which it provides this disclosure, and may provide disclosure for an additional year in each of the two subsequent annual filings in which this disclosure is required."

Connecting the Dots

The final rule's requirements give calendar-year-end companies approximately six to nine months to provide the disclosures, and many activities need to be performed before that deadline. The following steps represent a sample timeline for addressing the new requirements:

- *Now* — Management reviews the final rule and develops an approach for tackling the disclosure requirements, including identifying the peer group, the company-selected measure, and the measures to be included in the Tabular List. In addition, management needs to determine the ongoing annual process, including identifying stakeholders, dependencies, and data requirements as well as establishing a timeline for meeting the requirements.
- *October compensation committee meeting* — The compensation committee reviews management's approach.
- *November to December* — Management performs preliminary calculations and develops the disclosure controls and procedures to be used for live calculations. As part of this step, management needs to ensure that information is available for prior years related to adjustments to defined benefit and actuarial pension plans and stock-based compensation, for which additional actuarial or fair value calculations may be required.

- *December compensation committee meeting* — Management shares initial calculation, including the shape, form, and location of the new disclosures. The compensation committee reviews the preliminary calculations and provides feedback.
- *January to February* — Management uses the final numbers to perform calculations (for fiscal years 2022, 2021, and 2020 [if not an SRC]). Management develops language and graphics (as needed) to describe the pay versus performance relationship. The compensation committee reviews and approves the executive compensation disclosures, including the new pay versus performance requirements.
- *March or April* — The new disclosures are included in the proxy statement.

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