

A deep dive into the long awaited pay-for-performance disclosures

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Twelve years after the Dodd-Frank Act became law and seven years after the SEC initially proposed a rule to implement the mandated pay-versus-performance disclosure, the SEC has approved a **final rule**. The rule requires US public companies to provide a table that (i) discloses the relationship between executive pay and company performance using total shareholder return (TSR), net income and a company-selected performance measure, and (ii) compares company and peer group cumulative TSR performance, each over a five-year period. Companies must describe the relationship of pay to the measures in the table using graphics and/or narrative and also list three to seven important measures that link pay to performance. The disclosure must be included in proxy and information statements for fiscal years ending on or after December 16, 2022. There's a phase-in period for the table so only three years of information will be required for the 2023 proxy. Complying will require new equity award and pension calculations and analyses.

Given how extensive the new disclosures are, companies should quickly take the following steps: form a team of HR, accounting and legal experts, compensation consultants, and pension plan actuaries; identify three to seven performance measures and choose which one to include in the table as the most important measure; implement processes (or build on existing processes) to calculate compensation actually paid and company and peer company cumulative TSR; populate a pro forma table; and consider what conclusions investors might draw and what narrative disclosures would best demonstrate the company's pay-for-performance link.

Highlights

The final rule (new Item 402(v) of Regulation S-K) expands executive pay disclosures by adding a nine-column "pay-versus-performance" table and descriptions of the relationships between a company's actual executive pay and performance, and between cumulative TSR performance of the company and its peer group companies. The disclosure must be in proxy and information statements in which executive compensation disclosure is required.

New table and narratives. Proxies and information statements must include:

- A table showing for each of the five most recently completed fiscal years (subject to a phase-in period):
 - CEO Summary Compensation Table (SCT) total compensation and the total compensation "actually paid" to the CEO (i.e., SCT pay with adjustments to equity and pension values)

- Average total SCT compensation and compensation actually paid to other named executive officers (NEOs)
- Company's cumulative TSR
- Cumulative TSR of a company-selected index or peer group (weighted according to market capitalization at the beginning of each period for which TSR is reported)
- Company's net income
- Company-selected financial performance measure used to link pay to performance
- Descriptions (using graphs or narrative, or both) of:
 - Compensation actually paid to the CEO and other NEOs compared with the company's cumulative TSR
 - Company's cumulative TSR compared with peer group cumulative TSR
 - Relationship between compensation actually paid and each performance measure
- List of three to seven performance measures most important for linking compensation actually paid to performance

Compensation actually paid is total SCT compensation with adjustments for equity awards and pension values (discussed below).

Scope of the rule

Covered executives. Pay for the CEO (referred to in the rule as the principal executive officer or PEO) is disclosed individually. If a company had more than one CEO during any of the years covered by the table, the total amount paid to each CEO would be reported separately in additional columns (with N/A for years the individual wasn't CEO). But because the identity and number of NEOs varies from year to year, average pay is shown for the remaining NEOs in single column.

Covered years and phase-in period; newly public companies. Companies, other than Smaller Reporting Companies (SRCs), disclose information from the five most recently completed fiscal years. But the requirement to show five years of data is phased in: For the first filing that includes the disclosures, only the most recent three years of information is required. Another year is added in each of the next two filings. For newly public companies, disclosure is required only for years that the company was public and isn't required for Form S-1 "going public" registration statements.

Smaller reporting companies. The disclosures are scaled down for SRCs. SRCs have to provide information for only three years, and don't have to include peer company TSR. As is the case for all SRC filings, covered executives include the CEO and two other NEOs, and pension amounts are excluded. Inline XBRL tagging (discussed below) isn't required until the third year of compliance. For the first filing

where compliance is required, information for only two years must be provided; another year will be added in the next proxy filing.

Covered companies. The rule covers public companies subject to US executive pay disclosure rules but exempts:

- Emerging growth companies, which provide simplified SCT disclosure and are specifically exempt from the pay-for-performance requirement by the JOBS Act
- Foreign private issuers, which are not subject to US proxy rules
- Registered investment companies, which are typically externally managed and don't have NEOs

There's no exemption for controlled companies.

Pay-versus-performance table and narrative

Pay-versus-performance table. The nine-column table shows CEO compensation and average compensation of the other NEOs, measured two ways — SCT total compensation and compensation “actually paid” — alongside TSR for the company and for a peer group or index, the company’s net income and a company-selected performance measure:

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

* Not required for SRCs.

Footnotes must:

- Explain the equity award and pension values deducted from or added to the SCT total compensation figure to produce the amounts in columns (c) and (e) and any assumptions made in the valuation of equity awards that differ materially from SCT assumptions
- Name each CEO and other NEO included in the table for each year and the fiscal years in which they were included

Narrative or graphic description of pay-for-performance relationship. The company must clearly describe, using the information presented in the table, the relationships between each of the financial performance measures in the table and the compensation actually paid to the CEO and, on average, the other NEOs over the company's five most recently CFYs, as well as the relationship between the company's TSR and the TSR of the companies in its peer group or index. This disclosure has no prescribed format — companies can use graphs or narratives, or both.

List of performance measures. Companies must provide a tabular list naming the three to seven performance measures that the company considers are most important to measure the link between executive compensation and company performance. The list must include the financial performance measure the company chooses for the table's company-selected measure. Companies may also include non-financial measures that they consider to be among their most important measures as long as they list at least three financial measures (or fewer if they use less than three) but can't disclose more than seven in total. Companies may have separate lists for the CEO and other NEOs but each list must separately satisfy these requirements. Except for the most important company-selected measure that appears in the full table, companies don't have to rank or describe the measures, or discuss their relationship to pay.

Financial performance measures include stock price, TSR, and measures presented in accordance with the accounting principles used in preparing the company's financial statements or measures derived from those measures. They don't have to be included in the company's financial statements or SEC filings. All other performance measures are considered non-financial performance measures.

Calculating compensation actually paid

Compensation actually paid is the SCT total compensation figure with adjustments to equity award and pension values. There's no adjustment to any of the other SCT columns or the SCT above-market or preferential earnings on nonqualified deferred compensation value that is in the same SCT column as the pension value. The pension and equity adjustments are intended to align values with "realizable pay".

Equity-award adjustments. Companies must subtract the grant date fair value reported in the stock awards and option awards columns of the SCT and add or subtract the following:

Award	Calculation
Awards granted in covered fiscal year (CFY) that are outstanding and unvested as of end of CFY	Add year-end fair value
Prior year awards outstanding and unvested as of end of CFY	Add positive (or subtract negative) change in fair value as of end of CFY (from end of prior year)
Awards that are granted and vest in the same CFY	Add fair value as of vesting date
Prior year awards that vest in CFY	Add positive (or subtract negative) change in fair value as of vesting date (from end of prior year)
Prior year awards that fail to meet vesting conditions during CFY	Subtract fair value at end of prior year
Dividends or other earnings paid on all awards in CFY prior to vesting date	Add dollar value, unless otherwise reflected in fair value of award or included in another component of total compensation for CFY
Repriced vested options or stock appreciation rights (SARs)	Add incremental fair value

For performance awards, the number of shares valued as of the end of the CFY is based on the probable outcome of the vesting conditions as of the last day of the year.

Footnotes must include the following:

- Each of the amounts added and deducted due to equity award adjustments
- Any assumptions made in the valuation of equity awards that differ “materially” from those disclosed as of the grant date (when multiple awards are being valued, the footnote may show a range or use a weighted average amount)

Observations. For financial reporting and SCT and Grants of Plan-Based Awards Table purposes, companies show the grant date fair value of equity awards. But to populate the 2023 proxy table with changes in value from one year to the next, companies will need the following year-end fair values for awards that remain outstanding at the end of the CFY and interim fair values for awards that vest or are forfeited during a CFY for each of fiscal years’ 2020, 2021 and 2022:

	Granted in CFY	Granted in Prior Years*
Awards outstanding at end of year	Yes	Yes
Awards vested during year	Yes	Yes
Awards forfeited during year	No	Yes

* To calculate changes in value for 2020, companies will need 2019 values.

The complexity of calculating year-end and interim values depends on the types of awards granted:

- Service-based full value awards. The fair value generally equals the stock price times the number of shares underlying the awards.
- Performance shares with “performance” (e.g., earnings per share) conditions. The fair value generally equals the stock price times the number of shares underlying the award that are expected to vest. Companies already (i) adjust accounting expense each quarter based on the number of shares expected to vest and (ii) show the number and value (based on stock price) of shares expected to vest as of the end of the year in the Outstanding Equity Awards Table.
- Performance-based awards with “market” conditions (TSR or stock price). The fair value is the Monte Carlo simulation value (using updated valuation assumptions which already incorporate the number of shares underlying the award that are expected to vest).
- Stock options and SARs. The fair value is the Black-Scholes value (using updated valuation assumptions) times the number of shares underlying the award.

Companies can leverage their current processes but should alert their internal and/or external resources responsible for calculating grant date fair values that they will need additional calculations.

Pension adjustment. Companies must adjust SCT compensation by subtracting the change in the actuarial present value of the executive’s defined benefit and actuarial pension plans and adding the following:

Component	Calculation
Service cost	Actuarially determined present value of benefits for CFY
Prior service cost	Entire cost of benefits attributed to services rendered in periods prior to a plan amendment or initiation

Service cost and prior service cost must be calculated using the same methodology and assumptions used for the company’s financial statements under US GAAP in accordance with FASB ASC Topic 715. A footnote must include each of the amounts added and deducted due to pension value adjustments.

Observations. Including service cost, instead of the SCT change in actuarial present value for pension benefits, better represents benefits actually earned during the year. This approach removes most of the volatility associated with discount rate and mortality table changes that can significantly affect the SCT value. However, service cost includes an allowance for future pay increases that may never materialize and doesn’t fully capture the effect of unanticipated increases or decreases in pay levels.

Prior service cost was added because service cost doesn’t fully account for changes in the value of an executive’s expected benefit following plan amendments or initiations. However, it might overstate pay for the year because it includes, all in one year, the full impact of a plan amendment or initiation regardless of the period over which the benefits are amortized (although this is also true for the SCT value).

Companies should alert their actuaries that they will need service cost and prior service cost for each individual NEO for each CFY in the table. Actuaries already provide these amounts on an aggregate basis for all plan participants for financial statement reporting.

Measuring financial performance

The table must include three financial performance measures: TSR, net income and a company-selected financial measure.

TSR. Companies must calculate and compare their cumulative TSR and that of their peers over a five-year “measurement period.” Companies can use either the peer group or index used in the performance graph already included in the annual report (under Item 201(e) of Regulation S-K), or the peer group discussed in their CD&A for compensation benchmarking. The measurement period starts as of the market close on the last trading day before the earliest fiscal year covered by the table and runs through the end of the last CFY.

Consistent with the annual report’s performance graph:

- The closing price at the start is converted into a fixed investment of \$100 in the company’s (or each peer company’s) stock. For each fiscal year, the amount included in the table is the value of this fixed investment based on the cumulative TSR as of the end of that year. In other words, Y1 includes TSR for just the first year in the table, Y2 is cumulative TSR over two years, etc., so that Y5 includes cumulative TSR over the full five-year period covered by the table.
- If the peer group isn’t a published industry or line-of-business index, the names of the companies must be disclosed.
- Each peer company’s returns must be weighted according to market capitalization at the beginning of each period for which TSR is reported.
- If the peer group changes, the company must restate all of the years in the table using the new peer group TSR, and explain, in a footnote, the reason for the change, and compare the company’s cumulative TSR to that of both the old and new group.

Observations. Companies that use their compensation benchmarking peers for the TSR comparison rather than the same peers as are in the annual report performance graph will have more work to do, particularly if the peer group is frequently updated.

Net income. Companies must report their total net income for each CFY. The SEC believes that, although net income may not be frequently used directly in setting compensation, it’s closely related to other profitability measures that are used and is a widely understood and standardized GAAP measure. The SEC also believes it could complement TSR, particularly where a company thinks TSR doesn’t fully reflect company performance.

Company-selected financial measure. Companies must select, from the list of three to seven financial performance measures, the most important financial measure that isn't required to be included in the table but is used to link compensation actually paid to performance for the most recent CFY (i.e., if the most important measures are TSR and net income, the company would have to select a different measure). This financial performance measure doesn't have to be in the company's financial statements or an SEC filing but the company must explain how the number is calculated from the audited financial statements; a formal GAAP reconciliation is not required.

If a company selects a different measure than the one used in the prior fiscal year, the table header would show the new measure and the column would be restated even though the new measure may not have been the most important measure for the entire period covered by the table. The release includes this example: "If the Company-Selected Measure for the most recent fiscal year was total revenue, the company would title the column 'Total Revenue' and disclose its quantified total revenue performance in each covered fiscal year."

Observations. Including a company-selected performance measure in the table and providing a list of three to seven measures gives companies more flexibility to tell their pay-for-performance story but the pay-for-performance comparison in the table is company TSR to peer company TSR, keeping the primary focus on TSR.

Supplemental disclosures

Companies can supplement the required disclosures with additional pay or performance measures or additional years of data if doing so provides useful information about the relationship between pay and company performance. Supplemental disclosures must be clearly identified, not misleading, and no more prominent than the required disclosures.

Observations. Companies may want to explain pay-for-performance disconnects that arise, such as:

- Pay and TSR performance timelines may not align (e.g., long-term incentive awards cover different service or performance periods than the periods shown in the cumulative TSR column).
- If peer companies change, or the company selects a new performance measure to include in the table, prior period performance results are restated using the new peer companies and new performance measure, neither of which applied for those periods.

Finally, the table doesn't compare company pay to peer company pay. At the risk of making proxies even longer, companies may want to supplement the required disclosures with additional metrics and peer company pay comparisons if that would better tell their story.

Disclosure location and tagging

Location. The rule doesn't specify where the disclosures should be located within the proxy or information statement. The disclosures aren't technically part of the Compensation Discussion and Analysis (CD&A), although companies may choose to include them there. But because the disclosures

— unlike the CD&A — aren't incorporated by reference into Securities Act filings, companies may decide to put them in a separate section to limit liability for disclosure violations.

Inline XBRL tagging. The table and accompanying narrative and graphics must be presented in Inline XBRL — a tagging format already required for Form 10-K financial statements, but a first for proxies. Inline XBRL format is machine readable, making it easier for investors to download and analyze the pay-for-performance data and compare it across companies. The Inline XBRL version will be an exhibit to the proxy or information statement filed with the SEC. Each data element in the pay-for-performance table must be tagged separately, and footnotes and narrative/graphics are block-text tagged.

Action steps

The new disclosures are extensive and will require a lot of work and increase the length and complexity of executive pay disclosures. The rule is effective for the 2023 proxy season so there's no time to waste. To prepare for the new requirements, companies should:

- Form a team of HR, compensation consultants, accounting and legal experts, and pension plan actuaries
- Identify three to seven performance measures and choose which one to include in the table as the most important company-selected measure for the CFY
- Implement processes (or build on existing processes) to calculate compensation actually paid and company and peer company TSR, and consult outside experts as necessary
- Populate a pro forma table
- Monitor policy updates to see whether proxy advisors and investors decide to use the SEC's version of compensation actually paid in their pay-for-performance assessments (e.g., ISS has its own realizable pay calculation)
- Consider what conclusions investors might draw from the disclosure, and what narrative disclosures would best demonstrate the company's pay-for-performance link

Many companies already compare realized or realizable pay, with varying definitions, to company performance in their proxies so this new requirement may be an extension of what companies are already doing. However, the table is prescriptive except for the company-selected measure, not principles-based, so advance preparation will be critical in ensuring the disclosure is compliant. Where companies do have flexibility is in how they discuss the pay-for-performance relationships (e.g., narrative or graphics) and whether they include supplemental disclosures to best tell their own pay-for-performance story.