Pearl Meyer & Partners
Comprehensive Compensation℠

# Client Alert

January 3, 2007

## Highlights of the SEC's Last-Minute Changes to Stock-Based Compensation Reporting Rule

Responding to concerns about how executive equity grants will be calculated under new compensation disclosure rules in 2007, the SEC approved a change to the **Summary Compensation Table** (SCT) that generally requires companies to report the accounting cost of grants, rather than their full fair value on the date of grant. The amendment will alter the amounts that would have been reported for stock and option awards under the original rules and may have a significant impact on who is disclosed as a Named Executive Officer (NEO).

- ***PM&P Observation:*** *While some commentators have criticized this last minute change as a holiday gift to companies at the expense of investors, the changes could in fact reduce <u>or</u> increase the total compensation value that would have been reported under the originally approved rules, as explained below. Moreover, the full grant date fair value will continue to be reported in a supplemental proxy table.*

The revised **Summary Compensation Table** will now include the annual value of equity awards based on their annual accounting cost under FAS 123R (with one major difference described below), rather than the full fair value as required under the originally approved rules. Additionally, a column will be added to the **Grant of Plan-Based Awards Table** that reports the full fair value of the equity award (i.e., the amount included in the **Summary Compensation Table** under the originally approved rules).

<u>For purposes of executive compensation disclosure, estimated future forfeitures of equity awards will not be taken into account.</u> This is a significant departure from FAS 123R, which generally allows companies to estimate forfeitures and to revise compensation costs accordingly each accounting period as awards actually vest or are forfeited. Under the newly revised rules, reported compensation cost will be adjusted only if forfeiture occurs. This could result in disclosure of negative compensation if the forfeiture exceeds the accounting charge for other awards that year.

Executive compensation disclosures will now reflect important nuances of FAS 123R including:

- Recognizing the value of an equity award over the service period, rather than in the year of grant, as required under the originally approved rules.

- Reporting of the full grant date fair value of awards made to employees eligible for retirement and who are entitled to retain their equity awards upon retirement.

    - ***PM&P Observation:*** *While not a change from the originally approved rules, this requirement will now make grants to such individuals appear inflated compared to identical grants to individuals who are not retirement eligible, potentially affecting who is an NEO.*

- Reporting compensation costs for unvested awards granted in earlier years, but which vest in the current year.

    - ***PM&P Observation:*** *While 2006 compensation may be reduced due to FAS 123R's consideration of the service period, this decline could be offset by recognition of prior awards that vest in 2006. As a result, the total compensation reported under the revised disclosure could actually be higher than under the original rules.*

- Accounting for "liability" awards (including awards with a cash-based settlement, such as cash-settled stock appreciation rights) based on the stock's fair market value, where the accounting charge is not fixed at grant and may increase or decrease over the vesting period.

- Requiring, pursuant to FAS 123R, that companies estimate the portion of performance-based awards likely to be earned. Compensation reported for performance-based awards may change over time, as the estimated probability of achieving the performance condition changes.

    - ***PM&P Observation:*** *Changes in stock price (with respect to liability awards) and the probability of achievement of performance will affect the value of reported compensation, as well as determination of who is an NEO.*

## What to do now

- Revise any previous mock up of your compensation tables based on these changes, working with the financial reporting function to coordinate FAS123R costs. Remember to include FAS 123R values for the portion of grants vesting in 2006 that were made prior to 2006.

- Determine if the NEO group originally slated for inclusion in the SCT has changed. The revised rules generally will affect the total compensation reported in the Summary Compensation Table, which in turn governs determination of NEOs other than the CEO and CFO.

- Pay special attention to situations where equity grants were made to individuals who are eligible to retire. This may significantly affect whether such retirement-eligible individuals are now considered NEOs, while causing non-retirement eligible recipients to drop out of the NEO group.

- Going forward, be prepared to explain variances in liability and/or performance-based awards from amounts reported in previous years, as these may vary significantly from year to year.

- Inform the department or individual responsible for the financial reporting of equity grants of what information will be required under the new disclosure rules.

For a more detailed review of the SEC's changes, please see our additional Client Alert entitled: ***SEC Adopts Changes to the New Executive Compensation Disclosure Rules: Changes More Closely Align Disclosures with Accounting Rules*** available on our website at www.pearlmeyer.com.

Pearl Meyer & Partners
Comprehensive Compensation®

www.pearlmeyer.com


**NEW YORK**
445 Park Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

**ATLANTA**
One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

**BOSTON**
132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

**CHARLOTTE**
1348 Matthews Township Pkwy, Suite 250
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

**CHICAGO**
123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

**HOUSTON**
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

**LOS ANGELES**
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com