Snapshot

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Pay versus performance: Compensation 'actually paid'

The SEC's Final Rule, *Pay Versus Performance*, adds Item 402(v) to Regulation S-K, which, among other things, requires companies to disclose compensation "actually paid" to the principal executive officer (PEO), as well as average compensation "actually paid" to other named executive officers (NEOs) other than the PEO, in certain proxy and information statements. To compute compensation "actually paid," certain adjustments are required to the total compensation amounts disclosed in the summary compensation table, as described in the sections below.

Defined benefit and actuarial pension plans

- *Deduct* the aggregate change in the actuarial present value of all defined benefit and actuarial pension plans.
- *Add back* the following amounts computed in accordance with U.S. GAAP:
  - *Service cost:* Actuarially determined service cost for services rendered by the executive during the applicable year
  - *Prior service cost:* The entire cost of benefits granted 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 plan amendment or initiation

Smaller reporting companies (SRCs) aren't required to disclose the change in the actuarial present value in the summary compensation table and, therefore, do not need to make these adjustments to compute compensation "actually paid."

Grant Thornton insight: prior service cost

The adjustments for pension benefits require registrants to recognize the full prior service cost for any plan amendments during the fiscal year. In contrast, U.S. GAAP allows registrants to defer and amortize these costs over the expected remaining service period.

Equity awards

- *Deduct* the equity award amounts included in the summary compensation table.
- For awards granted during the year:
  - *Add* the fair value as of the end of the year for awards that are unvested and outstanding.
  - *Add* the fair value as of the vesting date for vested awards.

Grant Thornton insight: fair value considerations

In estimating the fair value of plain vanilla stock option awards issued at-the-money, the common practice is to utilize a Black-Scholes model, with the term equal to the expected life of the options. Since the option would not be expected to be at-the-money at the forfeiture date or at year-end, the expected life of the options for the proxy filing is likely different from both the expected life as of the grant date and the remaining expected life estimated as of the grant date.

To adjust the expected life, a company has two options: (1) use a behavioral model, such as a lattice model or a Monte Carlo simulation, to estimate the fair value of in-the-money or out-of-the money awards, or (2) use a behavioral model over the contractual term of the options in order to estimate the expected life, which then can be used in a Black-Scholes model to estimate the fair value of in-the-money or out-of-the money awards. Both these approaches would factor in the relationship between the stock price and the strike price as of the valuation date into the fair value of the awards, in accordance with the guidance in SEC Staff Accounting Bulletin Topic 14, *Share Based Payments.*

Companies generally fall into two main categories when it comes to valuing awards: Those who outsource the option grant tracking and valuation to third-party vendors, and those who perform valuation in-house using a "simplified method" because the company does not have sufficient historical share option exercise experience to use as a basis for estimating the expected term. Many option expense calculation software providers are limited to working mainly with at-the-money options and cannot easily adjust their software to incorporate behavioral aspects necessary to estimate the fair value of in-the-money or out-of-the money options. Therefore, management may require support from third-party experts specializing in the valuation of options using behavioral models (lattice model or Monte Carlo simulation). Similarly, management may not have sufficient experience to implement more complex valuations in-house, thereby requiring support from third-party providers with ASC 718-related valuation expertise.

- For awards granted in prior years:
  - *Add/deduct* the change in fair value as of the end of the year compared to fair value at the end of prior year for unvested and outstanding awards.
  - *Add/deduct* the change in fair value as of the vesting date compared to fair value at the end of prior year for vested awards.
  - *Deduct* the fair value at the end of prior year for awards that fail to meet the applicable vesting conditions during the year.
- *Add* dividends or other earnings paid on stock or option awards during the year prior to the vesting date, unless already included in the fair value determination or in total compensation in the summary compensation table.

The Final Rule also requires footnote disclosures for any valuation assumptions that are materially different from those disclosed at the time of grant. Further, for any awards that are subject to performance conditions, the change in fair value as of the end of the year is based upon the probable outcome of such conditions as of the last day of the year.

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