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Finding Out What Execs Are Paid Is Tricky

By Alistair Barr

Finding out how much U.S. corporate executives are paid is tricky, partly because of a last-minute change to compensation disclosure rules by the Securities and Exchange Commission in 2006 which has a former top lawyer from the regulator still scratching his head.

"To this day why it was changed escapes me," said David Lynn, a partner at Morrison & Foerster LLP who was chief counsel of the SEC's Division of Corporation Finance, which oversees compensation disclosure. "There may have been some political reason that I wasn't privy to."

An SEC spokesman referred MarketWatch to a press release announcing the rule change in which then-Chairman Christopher Cox said the new requirements would be "easier for companies to prepare and for investors to understand."

Lynn, who was chief counsel in the corporate finance division from 2003 to 2007, led the rulemaking team that drafted sweeping revisions to the SEC's executive compensation disclosure rules.

The rules, officially adopted on July 26, 2006, required companies to disclose the pay of their chief executive, chief financial officer and next three highest-paid executives in a new table, along with a detailed description of the compensation. The theory was that, by getting this information out further in the open, excessive executive pay could be controlled more successfully than through strict regulatory limits.

'Christmas Present'

One major part of the new rules required companies to report the value of equity awards, such as stock options and restricted stock, based on the day they were given to executives - the so-called grant-date fair value.

But on Dec. 22, 2006, the SEC unexpectedly released interim final rules that significantly changed this requirement - a move that was described at the time as an "early Christmas present to public companies," according to law firm Kirkland & Ellis LLP.

Instead of grant-date values, companies were required to disclose the amount they have to expense in that particular year for equity awards under an accounting rule known as FAS 123R.

The SEC put out the new interim final rules without any meetings or solicitation of comments and they're still in effect today, according to Lynn, who is also editor of the Web site CompensationStandards.com.

An SEC spokesman said rule-making using public meetings is only one way the regulator operates. He also noted that there was a 30-day comment period after the interim final rules kicked in.

The result has been to make these important parts of compensation disclosure "incomprehensible and relatively useless," Lynn added, illustrating the point with an example.

If a company gives an executive 10,000 shares of restricted stock at $10 each which vest over five years, that award has a grant-date fair value of $100,000. That number would have been disclosed in the third "Stock Awards" column of the compensation table in the company's proxy, Lynn explained.

Under the revised SEC rules, the company would disclose $20,000 a year over five years. That reflects the expense to the company from the award as it vests over the period, Lynn said.

The same approach applies to options, although the calculation of the value of option awards is more complicated, taking into account more factors such as the volatility of the underlying stock.

Negative Numbers

If equity awards are based on executives meeting performance targets, the revised SEC rules also require companies to account for the probability of these awards being earned during the year in question.

If companies have tough years and executives are unlikely to meet performance goals or their stock options are deep underwater, the value of previous awards has to be reversed out of the compensation tables, Lynn explained.

The carnage of 2008 has left some companies disclosing negative equity award values this year, he said, while declining to comment on specific firms.

A recent example is Movado Group (MOV). The watch maker reported stock awards of negative $500,157 for four executives including CEO Efraim Grinberg during its 2009 fiscal year.

The negative numbers were disclosed because Movado reversed previously reported expenses associated with Performance Share Units it granted to the executives in May 2006 and April 2007. By the end of January 2009, the May 2006 awards were forfeited and the executives were unlikely to meet the performance targets for the April 2007 awards, the company explained in its proxy.

Piled Up

The SEC may have changed the rules because "there was perhaps some thought that the numbers would be lower this way," Lynn said. "That didn't turn out to be the case."

Companies used to give large equity awards to executives once, or infrequently. Now many grant stock and option awards every year.

That means the accounting cost of all these awards are piled up on top of each other, leaving some very large numbers in some companies' compensation tables, Lynn said.

"That is widely seen now as causing an enormous amount of confusion," he added.

One of the main problems is that the value of equity awards that's disclosed often bears no resemblance to compensation decisions made by the company during the year in question, Lynn explained.

Changing the rules back to require companies to disclose the grant-date value of equity awards would give investors better insight into compensation decisions, he argued.

That's important because clear disclosure of executive compensation gives investors a window into how companies are governed, Lynn said.

"It also gives investors insights into the approach and attitude of the CEO. Do you have an imperial CEO with lots of perks and bonuses or another type of leader who is compensated more in line with performance?" he added. "Executives and boards are the stewards of the assets of the company and how they're paid is an important element of judging their approach to the job."

Changes may be on the way. SEC Chairman Mary Schapiro has said that the regulator "is actively considering a package of new proxy disclosure rules that will provide further sunshine on compensation decisions."

In the meantime, investors will have to make do with the current system of disclosing executive pay. Here's a guide to reading the compensation tables, compiled with Lynn's help.

Who's In The Tables?

The chief executive and chief financial officer are always among the five named executive officers listed in the compensation table. The other three are the highest-paid executives other than the CEO and CFO. An executive is loosely defined as someone with a policy-making function at the company, so highly paid sales people are typically excluded.

Column One: Salary

In the world of compensation disclosure, this column is straight forward, mainly listing executives' annual salaries. These numbers are usually below $1 million, because paying over that would trigger larger tax bills for companies.

Column Two: Bonus

This is cash that companies decide to give to executives. It's not tied to any kind of strict plan or program that lays out performance goals ahead of time, Lynn said. While these are usually paid at the discretion of the board, some top executives have a minimum or fixed bonus agreement in their employment contracts, Lynn added.

Column Three: Stock Awards

Now we get to the tricky parts. Awards of restricted stock and restricted stock units are disclosed here. But the annual expense to companies of granting these awards is reported, not the grant-date value. These numbers can be confusing because they reflect the theoretical value of equity awards granted in the current year and previous years that are still vesting, Lynn explained. Even if an executive gets no new equity awards during a particular year, the compensation table could still disclose a big number. If awards have performance targets and those goals aren't met, companies have to reverse expenses from the grants that were reported in previous years. That can produce negative numbers in this part of the table.

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Column Four: Option Awards
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Stock options and stock appreciation rights (the economic equivalent of stock options) are listed here. The same potential for confusion exists, but it's more complicated than the previous column, according to Lynn. The main extra wrinkle is when executives are given options and then later it becomes unlikely they will vest - usually because the company's share price falls and the options are deeply under their strike price. The annual expense of options like these is calculated based on the probability of the awards vesting during the reporting period. If vesting is no longer probable, companies have to reverse out amounts that they disclosed in previous years, Lynn explained. More negative numbers are possible here.

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Column Five: Non-Equity Incentive Plan Compensation
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Long-term or annual incentive plans that pay out in cash are disclosed here. Most companies have some sort of plan that encourages executives to meet certain performance targets by offering a cash carrot. Similar plans that pay out in stock or options are disclosed elsewhere in the table. Any bonus that has a performance condition attached goes here.

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Column Six: Change In Pension Value And Non-Qualified Deferred Compensation earnings
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Defined-benefit pension plans and deferred compensation programs for executives are detailed here. If executives stick around for another year, the value of their defined pension plans often increases. If they reach a certain age, companies sometimes credit more service years or increase the ultimate payment to them by a certain amount to give them an incentive to stay on longer, Lynn explained. These changes in value are recorded in this part of the compensation table. Non-qualified deferred compensation plans are usually set up because executives max out on plans that qualify for tax breaks, such as 401Ks. Instead of taking all compensation straight away and being taxed on the income, some executives defer payment and invest the money. If executives generate returns on those investments that are higher than specific benchmarks, those above-market gains are considered compensation and disclosed in this column, Lynn explained.

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Column Seven: All Other Compensation
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This is where executive perks are disclosed. The incremental cost of an executive using a company's corporate jet for personal reasons would be reported here. Country club membership fees, 401(k) matching payments, insurance premiums paid on an executive's behalf, the cost of security and tax preparation services are other examples. The amounts are relatively low, but the disclosures can sometimes be controversial. "Many big companies are looking very closely at most big perks and deciding they're less inclined to support them as a separate element of compensation," Lynn said.

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Final Column: Total
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All the other columns are added up here. "It's totally a mishmash of numbers," Lynn said. "There's the actual salary and bonus, plus theoretical amounts, such as the annual expense of equity awards, which don't bear much resemblance to what's gone on during the year."

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