A User’s Guide to the SEC’s New Rules for Reporting Executive Pay

This special report outlines how Moody’s will use the new Securities and Exchange Commission (SEC) disclosure rules on executive pay to evaluate a board’s decision-making with respect to the structure, size and focus of pay-related performance incentives. Executive pay is incorporated into Moody’s credit analysis of rated issuers because compensation is a determinant of management behavior that affects indirectly credit quality.

The new SEC rules, which took effect this year, will likely shed light on pay practices and generally lead to more rigorous executive pay analysis for fixed-income investors. The rules give investors greater insight into board decision-making, the dynamics of board management, and the way performance incentives influence management behavior and retention of top-level executive talent.

This report comments on prospective improvements to specific disclosures and the other following pay-related issues:

- How Moody’s will use expanded disclosures on the value of executive pensions, severance and/or change-of-control payments. Until now, investors were not able to analyze fully these often sizable components of executive pay because companies gave them few specifics on actual payouts. Now, companies disclose much more detail, including specifics on potential payouts. Improved disclosure of equity grants also facilitates better analysis of pay decisions and incentives.
- How statement 123R grant date fair values for equity and long-term incentive plan awards are used by Moody’s to adjust total pay figures reported by companies in the summary compensation table to make comparative analysis meaningful.
- What Moody’s expects from the new Compensation Discussion and Analysis (CD&A) report, which provides boards with a real opportunity to better explain their pay philosophy and decisions.

EXPANDED DISCLOSURES ON PENSION, SEVERANCE AND CHANGE-IN-CONTROL PAYOUTS AND EQUITY

Moody’s believes the most striking expansion in pay disclosures relates to equity grants, the value of executive pensions, severance and/or change-of-control payments. This section describes how investors can use the new disclosures.

1. More Visibility Into Severance, Change-In-Control Payouts. This is an area in which the SEC has significantly improved disclosure. Traditionally, companies disclosed the material terms of severance or change-of-control arrangements, but rarely the potential payout. In fact, disclosures were sufficiently vague that it was very difficult to estimate potential payouts, particularly the value of early vesting of equity-based pay or the value of any tax gross-ups or continued benefits and perquisites.
Under the new disclosures, companies have to provide more detail as to the potential value of voluntary or involuntary severance payouts and change-in-control payouts. Companies must disclose the potential payout as if it had been made at the end of the last calendar year. The new rules provide companies with a fair degree of discretion as to how to present these disclosures. We have seen three types of disclosures: (1) a separate table for each named executive officer, showing the various types of payouts depending on what triggered the payout; (2) a table covering the named officers, by type of payout, e.g. “for cause” dismissal; or (3) narrative, non-tabular disclosures. In Moody’s view, standardized, tabular disclosures, which include a total payout figure, would make comparative analysis easier for investors.

Due to the weakness of past disclosures, we do not yet have adequate benchmarks so as to identify outlier payouts. Over time, as we gather more data, such outliers will become more apparent. In the meantime, Moody’s will look for unusual payout terms, such as:

- Cash severance payouts in excess of three times salary plus bonus
- The inclusion of equity in severance payout calculations
- “Single-trigger” or other unusual change-in-control payout provisions.

Suggestion for improving disclosures: Disclose severance and change-in-control payout figures in a standardized tabular format

2. **More Visibility Into Defined Benefit Plans**: Moody’s believes the enhanced disclosure surrounding the actuarial present value of the accumulated defined benefit pension plans for executives is also a significant improvement over prior years. In the past, investors had to wade through opaque actuarial tables to estimate annual payouts. Often this proved difficult. Investors also had little insight into the effect on potential liabilities of board decisions to award additional years of service to an individual’s pension entitlement.

Under the new rules, companies have to provide, for each named executive officer, the present value of accrued benefits for each individual’s defined benefit plans and provide narrative disclosures on any extraordinary items, such as additional-years-of-service awards.

Moody’s has yet to determine what constitutes outlier defined benefit plan values or deferred pay balances, because past disclosures have been weak. Traditionally, we have not commented much on this element of pay because estimations and comparisons have been difficult. Going forward, we will focus our analytical attention on those CEOs in the top quartile. Chart one shows that the CEOs in the top quartile of the 439 companies that had filed their proxy statements as of April 4, 2007, had $7.0 million and $4.6 million, respectively, for their accumulated defined benefit plan value and deferred compensation account balance. We will refine this analysis as more data becomes available.

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1. Single-trigger: A company typically makes a change-in-control payout when a certain percentage of shares change hands and the executive’s employment is involuntarily terminated or the executive leaves for reason, typically due to a demotion, with a defined period—often called a double-trigger payout. A so-called single-trigger payout is accelerated after the change of control takes place but the executive does not need to leave the company. As such, such mechanisms have the potential to encourage acquisitive behaviors that are not in the overall interests of the company. Other unusual triggers include: setting the change—in-control provision at a notably low level, for example, at 15% of equity, or linking the payout to an intermediate step, such as gaining shareholder approval, rather than to execution of the change in control.

2. On March 19, 2007, at the 2007 Spring Council of Institutional Investors meeting, John White, Director, Division of Corporation Finance, Securities and Exchange Commission, stated the SEC plans on evaluating a large number of company disclosures over the course of the 2007 proxy season with a view to determining whether new guidance—or even rule changes—is necessary for the 2008 proxy season.

3. Source: Equilar, Inc.
3. **Identification of grants of in-the-money stock options, target/maximum grant-based plan awards.**

The grants of plan-based awards table provides some useful information beyond providing data that Moody's uses for adjusting total pay figures in the summary compensation table (see below). Those companies that continue to award “in-the-money” stock options have to identify these awards and explain the methodology used to price the options. We view these additional disclosures as useful given the stock option backdating scandal that engulfed over 150 U.S. companies in 2006. This table also highlights threshold, target and maximum payout levels for from cash-based and equity-based incentive plans, which provides some indication of future potential awards.

4. **More detail on outstanding equity awards and value of vested or exercised stock.**

The SEC significantly increased the level of disclosure on outstanding equity awards held by executives. In the past, companies only had to disclose, on an aggregated basis, the number and “in-the-money” value of exercisable and unexercisable stock options, along with the gains realized through exercising options.

Companies now have to disclose: (1) each outstanding unexercised option (on a grant-by-grant basis), and unvested stock awards and long-term equity incentive plan awards that have not paid out (on an aggregate basis) in the outstanding equity awards table; and (2) the amount realized from exercised options and the value of vested equity awards in the option exercises and stock vested table.

Moody’s will continue to evaluate the reasoning behind large stock option exercises by senior executives. To the extent executives are exercising options because the options are nearing the end of their term, we will not spend much time on such analysis. However, where the exercises highlight upcoming executive retirements, we will focus on the quality of management succession planning, particularly when it involves the CEO. Similarly, when there appears to be no obvious reasoning, we may probe as to whether senior management is losing confidence in the company’s future performance.

Moody’s believes the detailed disclosures of past awards in the outstanding equity awards table provide an indication of the retention value of unvested awards because an investor can see when the largest element(s) of unvested equity will vest and can consider how the vesting might affect the company’s ability to retain that executive in the future.

However, Moody’s views as a retrograde step the SEC’s decision to no longer mandate the disclosure of the aggregate unrealized value of exercisable and unexercisable stock options. While investors can calculate the figures using the data disclosed, it can be a tedious task given that most executives have numerous awards outstanding. We believe the aggregate figure acted as a proxy for the totality of past option award decisions, and highlighted, in a simple way, the level of “leverage” in an individual’s stock option awards; that is, it showed the effect of share price movements on the individual’s wealth and in so doing helped indicate the degree to which the individuals might become fixated on corporate actions that led to positive share price movements, particularly over the short term.

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4. See Moody’s special comments: Update: 11 issuers see rating actions linked to option timing probes, November 2006 (100524); Stock Option-Timing: Scrutiny and Risks Increase, July 2006 (98494); Stock Option “Backdating”, June 2006 (97760).
5. **More detail on deferred pay accounts.** Companies that have deferred compensation arrangements for executives now have to provide much greater disclosure as to the nature of these arrangements, the annual contributions and withdrawals to such arrangements, and the aggregate value of year-end account balances. Moody’s will use these disclosures in a targeted way. Where the aggregate value is significant in an absolute sense, we will analyze terms of the arrangements to assess how favorable the terms are compared to peers and consider what this suggests regarding the quality of the board decision-making process.

**MOODY’S STANDARD ADJUSTMENTS TO TOTAL PAY FIGURES**

Traditionally, Moody’s has focused much of its analytical attention on the total pay of the five named executive officers who are covered by the SEC rules, particularly the CEO. We have taken the view that the best way to evaluate total pay, and therein the quality of board decision-making surrounding executive pay, is to evaluate total pay from the perspective of “what did the board decide to give to the executives in a given year?”

In the past, Moody’s has aggregated the following components of pay:

- Base salary
- Annual bonus payouts
- Long-term incentive plan (LTIP) payouts
- The value restricted stock and/or option awards
- “Other compensation”, e.g. perquisites, company 401(k)/savings plan contributions, etc.

We have included LTIP payouts, as opposed to future target awards, because, typically, boards retain the right to override formulaic payouts such that they have some discretion over the ultimate amount received by the executive. In contrast, we have included the grant date fair value of equity awards, rather than realized gains, because when boards make the awards they don’t know, nor do they have control over, the final gains—they only know the estimated value of the award at grant. Our primary interest in analyzing pay is to gain insight into the compensation committee’s intent regarding the structure, size and focus of incentives. Determining the dollar value of compensation ultimately transferred to executives, while potentially relevant, is a secondary interest.

In evaluating executive pay, we differentiate between short-term (base salary, annual bonuses and other annual pay) from long-term pay (LTIPs and equity-based pay) so as to determine how pay encourages long-term decision-making.

One of the major elements of the new SEC pay disclosures is a revised summary compensation table (SCT). For the first time, a total pay number has to be disclosed by companies, along with greater detail on what the SEC considers to be key elements of total pay. Moody’s applauds the SEC’s decision to mandate total pay disclosures with a view to making it easier for investors to analyze and compare pay across companies. However, in deciding upon the mandatory disclosures in the SCT, the SEC has not chosen to mandate disclosures that illuminate what the compensation committee decided to pay executives in a given year, but has chosen instead to base disclosure on the cost of pay for that year under the financial accounting rules.

This shift has turned the focus of pay disclosure in the SCT away from future incentives and back toward tallying costs already incurred. In so doing, Moody’s believes the SEC has diminished the potential value of the new SCT as a forward-looking analytical tool for assessing the incentives executive pay awards create in the near and longer term. As a result, Moody’s makes a number of critical adjustments to the executive pay disclosures intended to arrive at what we believe to be a more meaningful and useful—though still not optimal—total pay figure. Moody’s will use these adjustments in our executive pay analysis of rated issuers and in our published research on issuers’ pay practices.

5. The focus on CEO is predicated on the view that: (1) it is easier to compare CEO pay across companies because the CEO is always included in the disclosures; and (2) other executives are keenly aware of what is considered important to the CEO in terms of meeting his or her goals, so the CEO’s pay has an important signaling effect on management and employees at large.

6. We use the company’s disclosed grant date fair value (or, prior to stock option expensing, we estimated our own value using a Black-Scholes option pricing model if a value was not disclosed).
Our adjustments are described in reference to illustrative pay disclosures for the imaginary ABC Corporation. Chart two highlights the SCT for ABC’s CEO John Smith.

Chart 2

**ABC’s Summary Compensation Table**

<table>
<thead>
<tr>
<th>Name and Principal Position</th>
<th>Year</th>
<th>Salary ($)</th>
<th>Bonus ($)</th>
<th>Stock Awards ($)</th>
<th>Option Awards ($)</th>
<th>Non-Equity Incentive Plan Compensation ($)</th>
<th>Change in Pension Value and Nonvested Defined Compensation ($)</th>
<th>All Other Compensation ($)</th>
<th>Total ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO John Smith</td>
<td>2008</td>
<td>750,000</td>
<td>250,000</td>
<td>1,243,678</td>
<td>1,387,646</td>
<td>1,200,000</td>
<td>100,000</td>
<td>100,000</td>
<td>3,264,117</td>
</tr>
</tbody>
</table>

Includes contributions to 401(k)/savings plan, perquisites, etc.

FAS123 figures

- Potentially volatile – e.g. if defined plan assumptions are changed
- Only includes above-market and preferential earnings on deferred compensation

Chart three highlights the grants of plan-based awards table for Mr. Smith. Moody’s views this table as critical because we use some of that data to adjust the disclosures in the SCT.

Chart 3

**ABC’s Grants of Plan-Based Awards Table**

<table>
<thead>
<tr>
<th>Name</th>
<th>Grant Date</th>
<th>Estimated Future Payments Under Non-Equity Incentive Plans ($)</th>
<th>Estimated Future Payments Under Equity Incentive Plans ($)</th>
<th>All Other Option Awards: Number of Shares Underlying Options ($)</th>
<th>All Other Option Awards: Fair Value of Options ($) ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>John Smith</td>
<td>3/9/2006</td>
<td>30/1/2006</td>
<td>3/22/2006</td>
<td>50A</td>
<td>750,000</td>
</tr>
</tbody>
</table>

Fair value of stock awards

Fair value of target multi-year equity-based incentive

Fair value of option awards

Typically, multi-year equity-based incentive plans

Only performance-based cash incentive plans – can be annual or multi-year

Often, this is the current year annual/incentive plan award

Moody’s Special Comment
Who's in the new SCT? What years are covered?

In the past, executive pay disclosures focused on the CEO and next four most highly compensated officers. “Most highly compensated” was determined by reference to salary and annual bonus payouts. The CFO was only included if he or she was one of the most highly compensated executive officers, by that definition. Now, the CFO has to be included regardless of his or her total pay. Also, the decision on which other three executive officers to include is determined by reference to total pay, which includes equity and long-term incentive plan payouts. As a result, the individuals listed in 2007 disclosures may differ from prior years.7

Because the new rules are being phased in over three years, companies are not required to restate pay figures for prior years under the new disclosure requirements. This means that, during the phase-in period, investors will have to shuffle between several proxy statements to evaluate pay trends.

The base salary column in the SCT remains unchanged from prior years, so Moody’s uses the reported figure. With regard to “other compensation,” companies used to disclose such pay in two columns (including perquisites, insurance plan costs and payments to 401(k) or other savings plans, etc.). Under the new rules, except for the annual change to defined benefit plan values and above-market or preferential earnings on deferred compensation, discussed below, these elements of pay are now aggregated in a single “all other compensation” column.8 Moody’s uses the full “all other compensation” figure in our total pay analysis.

With regard to the other elements of pay, Moody’s makes a number of adjustments to the data disclosed in the new SCT:

• **Annual bonus payouts.** In the past, companies disclosed in the bonus column any annual bonus payout, regardless of what triggered the payout. Under the new rules, companies have to differentiate between discretionary or guaranteed bonuses (which are disclosed in the bonus column) and payouts that are the result of formulaic, performance-based annual incentive plans (which are disclosed in the non-equity incentive plan compensation column).9 For example, if a board paid out $1 million in cash from a formulaic annual incentive plan, and another $500,000 discretionary annual cash bonus payout, the $1 million would be disclosed in the non-equity incentive plan compensation column and the $500,000 in the bonus column. Under the previous rules, the full $1.5 million would have been disclosed in the bonus column.

Moody’s believes this structure is confusing in two ways:

– At first glance, the so-called “bonus” column presents a misleading picture of the annual incentive payout because a significant majority of bonus payouts are formulaic in some way. Indeed, of 439 companies that had filed their proxy statements as of April 4, 2007, 71% disclosed nothing in the bonus column.10

– The non-equity incentive plan compensation column also includes any payouts from multi-year cash-based incentive plans. While many companies that have annual and multi-year cash-based plans are segregating the composite elements in a footnote to the column, they are not required to do so. As a result, investors have to comb through the CD&A (discussed below) to determine if a multi-year cash-based incentive plan exists. If one does not exist, they can assume the figure in the non-equity incentive plan compensation column is an annual payout. If one does exist, they need to read the footnotes, if any, and adjust the annual bonus payout accordingly, so they can better differentiate annual from long-term pay components.

**Moody’s adjustment.** Moody’s aggregates all annual bonus payouts into one figure. Where disclosures make it possible, we remove from the bonus figure any payouts from multi-year cash-based incentive plans.

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7. The SEC proposed mandating disclosure of the total pay of the top three non-executive employees. The initial proposal garnered significant criticism, because for some industries, such as the media, this would focus attention on “top talent” and not key decision-makers—the so-called “Katie Couric problem.” Subsequently the SEC narrowed the proposal to cover the top three paid non-executive employees in key decision-making roles in the organization. The SEC has yet to adopt this proposal. Moody’s believes that greater disclosure on key business line decision-makers who are not necessarily corporate officers would be useful. However, given that staffing structures differ so much between companies, we will concentrate much of our analytical attention on CEO pay because this is the most practicable basis for broad comparative analysis.

8. The new rules mandate more detailed disclosures of the elements included in the other compensation total.

9. All payouts from formulaic plans are to be in the non-equity incentive plan compensation column, even if the compensation committee retained discretion over the final payout. This includes payouts from plans where the available bonus pool is formulaic, but the actual payouts to individuals are not determined in reference to a formula.

10. Source: Equilar, Inc.
• **Stock awards and stock options.** In the past, in the SCT, companies disclosed the grant date value of unrestricted, restricted or performance-based stock awards, but only the number of stock options awarded. The potential value of the option awards was addressed in the option grants table, or, if not, it could be estimated using Form 10-K disclosures and a standard Black-Scholes option pricing model.

Initially, in July 2006, the SEC announced that under the new rules, companies would have to disclose in the SCT the full Statement 123R grant date fair value of stock awards and stock option awards—and both would be included in the total pay figure. (These figures are also disclosed in the new grants of plan-based awards table.) Moody’s believes that including the grant date fair values in the SCT and total pay figures is the most appropriate way to include such awards.

However, the SEC announced, in December 2006, that companies should disclose in the stock awards and options awards columns only the portion of the grant date fair value of the share-based compensation awards that was recognized during the year for financial reporting purposes as determined by Statement 123R. In so doing, the SEC moved from a more desirable value-of-award approach to a much less desirable cost-of-award approach. In Moody’s view, using the “attributed” amounts of compensation expense under Statement 123R in the SCT has clear drawbacks:

– The data is backward looking and bears little relation to the compensation committee’s intent in making the initial award
– The expensed portion of pay, under Statement 123R, provides a distorted picture of equity and total pay and makes total pay analysis over time and against peers difficult (for more detail, see Appendix One “How is stock-based compensation accounted for under Statement 123R?”). For example, the disclosed figures:
  ■ Will be understated for newly appointed executives or when the grant date fair values have been increasing in recent years.
  ■ Will be overstated if the individual received an unusually large grant in recent years, perhaps as a recruitment incentive or for signing a new employment agreement.
  ■ Could be notably different than in prior years in situations in which a named executive officer is “retirement eligible” or will become retirement eligible prior to the normal vesting period of an award.
  ■ Could change markedly from year to year, including being negative, if cash-settled equity has been issued because these figures must be adjusted each year to reflect share price volatility.
  ■ Could be negative if the actual outcome is different from the company’s initial estimation for equity awards with internal performance conditions, such as return on equity target.
  ■ The 2006 numbers, and the numbers for the years immediately after 2006, will be understated for the approximately 1,000 companies that accelerated vesting of stock options in 2005 prior to the full implementation of FAS123(R).

**Moody’s adjustment.** Moody’s uses the full Statement 123(R) grant date fair value of stock awarded and options granted, as disclosed in the grants of plan-based awards table, instead of the figures disclosed in the SCT stock awards and options awards columns.

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11. Includes both amounts recorded as compensation expense in the income statement and amounts earned during the period that are capitalized on the balance sheet.
12. Moody’s views share-based compensation as an expense when evaluating the quality and consistency of an issuer’s earnings, as stated in a December 2002 rating methodology, Analytical Implications of Employee Stock-Based Compensation (76882). However, we do not believe the expense figures should form part of the summary compensation table in companies’ proxy statements.
13. Although the special comment does not comment on the new disclosures for director compensation, Moody’s believes the full Statement 123R grant date fair value of stock or stock option awards should be disclosed in the new director compensation table, instead of the portion being expensed that year. With this change, Moody’s believes the new director compensation table would aid investor analysis of director incentives.
• **Multi-year incentive plans.** In the past, companies had to disclose in the SCT the value of LTIP payouts, regardless of whether the LTIP was cash- or equity-based. Moody’s used this payout number in our total pay analysis. Under the new rules, company disclosures on long-term incentive plans are more opaque, in Moody’s view. Cash-based LTIP amounts are included in the non-equity incentive plan compensation column when earned (regardless of when paid out), as noted above, while equity-based incentive plans are included in the stock award column under Statement 123R accounting. Under the new rules, it is difficult, if not impossible, to determine the ultimate payout from equity based LTIPs because companies provide little or no color as to the composite elements of the Statement 123R numbers in the SCT. We view the new approach as a step back from transparency.

*Moody’s adjustment.* Moody’s aggregates the payout from multi-year cash-based incentive plans (where this can be differentiated from annual payouts in the non-equity based incentive plan compensation column) and the target value of equity-based, multi-year incentive plans, as disclosed in the grants of plan-based awards table. We view this as a sub-optimal way to evaluate LTIPs, but without improvements to disclosures, we view this as the best approach possible.

*Suggestion for improving SCT disclosures:* Disclose all payouts from multi-year incentive plans in one column, regardless of whether the plan is cash- or equity-based

• **Change in defined benefit value and above-market deferred pay contributions.** As before, companies have to disclose company contributions to an individual’s defined contribution savings plans in the “all other compensation” column. In addition, under the new rules, companies have to disclose the annual change in the value of the defined benefit plan(s) and above-market or preferential earnings on deferred compensation. These are included in the total pay figure in the SCT.

*Moody’s adjustment.* As before, Moody’s includes the contributions to defined contribution plans in our total pay figure because we include the total “all other compensation” figure. However, Moody’s does not include the annual change in value of the defined benefit plan(s) or above-market or preferential earnings on deferred compensation in our pay analysis, because these contributions are heavily influenced by the terms and assumptions in the overall plans and are less tailored to the individual than the other elements of pay. Moreover, with regard to the change in value of the defined benefit plan(s), we believe this figure could bring misleading volatility to the pay figures because the value of a plan is influenced by a number of plan-based factors, such as accrual and discount rates.14

Only rarely will this portion of pay constitute a significant part of total pay, so, generally, Moody’s total pay analysis is not materially affected by excluding this element of pay. In fact, these elements of pay represented a median of 3% of reported total pay for the 439 companies that had filed their proxy statements with the SEC by April 4, 2007.15 However, we analyze the underlying facts when: this portion of annual pay is relatively high; or, as noted above, when aggregate deferred compensation balances and defined pension plan values (disclosed in separate tables) are relatively high.

*Suggestion for improving SCT disclosures:* Remove the annual change in defined benefit plan values and above-market or preferential earnings on deferred compensation from the SCT

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14. In fact, the annual change in defined benefit plan values can be negative (although the figure reported in the SCT will be zero in such a situation, with the company footnoting the negative figure).
15. Source: Equilar, Inc.
THE NEW COMPENSATION DISCUSSION & ANALYSIS (CD&A)

Beginning in 2007, companies have to include a Compensation Discussion and Analysis section (CD&A) as part of their executive pay disclosure, which is designed to give investors more explanation and insights into a board’s rationale for its decisions on top-level executive pay.¹⁶

We expect companies to put considerable effort into writing their CD&As because the section is subject to greater liability than its predecessor, the old board compensation committee report. Companies must “file” the CD&A and reference it in annual reports, requiring their CEO and CFO to attest to its accuracy. The legal burden is akin to what management faces in connection with the “MD&A” section of a company’s annual report on Form 10-K.

Moody’s hopes the additional focus on explaining pay will encourage companies to:

• Outline the overall pay philosophy
• Show the link between pay, strategy and performance
• Illustrate the behavior the board wants to see from management, due to its choice of compensation-related incentives
• Portray more clearly and precisely the structure of short-term and long-term compensation
• Simplify comparative analysis of one company’s executive pay against its peers
• Identify unusual or unexpected elements of executive pay

However, Moody’s is concerned that the additional legal burden attributed to filing the CD&A will encourage companies to veer towards legalese and boilerplate disclosures. Although it is still too early to be conclusive, Moody’s has found that many of the proxy statements already filed with the SEC in 2007 include long and often convoluted CD&As. As SEC Chairman Christopher Cox put it recently, in commenting on the SEC’s initial review of 2007 proxy statements, “we have far to go before we can say that legalese and jargon have truly been replaced by plain English. It’s clear that many companies are letting lawyers have the final say on the CD&A.”¹⁷

¹⁶. See Appendix Two for more detail on what is in the new CD&A.
The new requirements provide companies with significant discretion on what to include in the CD&A. In our view, this discretion diminishes the potential usefulness of the CD&A. In particular, at a minimum, we believe companies should have to disclose the exact performance metrics that drive short- and long-term payouts, along with the weightings for each metric. Performance metrics are used in awarding annual bonus payouts and, in an increasing number of cases, for long-term awards as well. In Moody’s executive pay analysis, we seek to consider the implications of performance metrics for long-term value creation, successful execution of strategy, and likely impacts on bondholder interests. Moody's has outlined previously that we view some performance metrics as less bondholder friendly than others. For example, we believe earnings per share is less preferable for bondholders than metrics tied to cash flow.18

In our view, performance metrics provide a clear illustration of management’s priorities; can indicate management’s risk appetite; and can influence directly management’s preferred financial strategy, for example, the level of dividends or purchases of company stock. In addition, performance metrics can point to potential future financial reporting risk, particularly when coupled with relevant accounting “red flags.” For example, when a company has been relatively aggressive in accounting for revenues, while, at the same time, including revenue as a key performance metric for determining executive pay.

We view as best practice the disclosure of the performance targets for each metric and performance vs. peers on those metrics, where known. We believe companies should list the companies used by the compensation committee in benchmarking pay, and provide a narrative explaining why those companies have been chosen, particularly when the reasoning is not self-evident.

Furthermore, Moody's believes the decision to no longer require a separate explanation of the decisions involving the CEO's pay is a retrograde step, particularly in light of the problems associated with evaluating total pay, noted above. We believe a narrative on the CEO's performance and pay provides investors insight into board decision-making.

Suggestions for improving CD&A disclosures:
• Disclose performance metrics and their weightings, along with a narrative on the peer group used by the compensation committee for benchmarking purposes
• Include a narrative on CEO pay and performance

Statement 123R requires all companies to recognize compensation expense in their income statements for all stock-based compensation awards. Under the new SEC pay disclosures rules, Statement 123R accounting values will also be used to report equity awards in the summary compensation table. While Moody’s will replace these figures using our standard adjustments, noted above, we believe that it is important that investors have a basic understanding of Statement 123R disclosures so they can better understand some potential for significant differences in the SCT figures over time and between companies.

Some of the key provisions of Statement 123R are:

1. **Measurement of compensation expense**
   Compensation expense (with a few exceptions) is measured based on the grant date fair value of an equity award. The grant date fair value of a stock option is typically determined through the use of an option pricing model, such as Black Scholes or more sophisticated lattice models. We are also beginning to see the emergence of market-based tools to value stock options, such as the “ESOARS” product created by Zions Bancorp.19
   An added level of complexity is introduced to the determination of the grant date fair value when an equity award contains performance conditions, such as:
   - **“Market conditions”, e.g. stock price hurdles.** These conditions are always considered in the determination of, and will generally reduce, the grant date fair value of an award. The expense is never reversed once it is recognized, even if the market condition is not satisfied ultimately.
   - **Internal “performance conditions,” e.g. return on equity (ROE).** When these conditions affect something other than vesting of the award, a company has to calculate multiple grant date fair values to cover all possible outcomes, e.g. various ROEs. The expense is recognized using an estimate based on the grant date fair value of the most likely outcome. However, the expense amount recognized ultimately will be adjusted upwards (or downwards) to reflect the grant date fair value of the actual outcome if different than the most likely outcome used to record estimated expense.

2. **Recognition of compensation expense in the income statement/proxy statement**20
   The grant date fair value of an equity award is recognized as compensation expense over the period of time an employee is required to provide service to receive the award (usually the vesting period). The most common types of equity grants are expensed as follows:
   - **Stock or stock options that vest at the end of a given period – so-called “cliff vested” awards.** Use a straight-line approach. E.g. for an award with a grant date fair value of $100 that vests at the end of four years, the company accounts for $25 in each of the four years.
   - **Stock or stock options that vest in equal annual installments over a given period – so-called “graded vesting”**. Companies make an accounting policy election either to expense the entire grant date fair value of such awards on a straight-line basis (as described above) or to expense such awards on an accelerated basis that breaks the awards into separate vesting tranches. E.g. for an award with a grant date fair value of $100, a quarter of which vests every year for four years, the company expenses $52.08 in year one ($25 + 0.25x$25), $27.08 in year two (0.5x$25 + 0.33x$25), and so on.

   The accounting treatment differs, however, for more complex equity awards:
   - **Equity that vests if internal performance conditions are met.** If a performance condition must be met for an award to vest, expense will ultimately only be recognized if the performance condition is satisfied. A company will recognize compensation expense prior to satisfaction of the performance condition based on its assessment of the probability that the performance condition will be satisfied. As noted above, the amount of expense ultimately recognized will be trued-up based on the actual outcome. This could result in the reversal of previously recognized compensation expense.

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19. We discuss the credit implications of a company’s use of these market-based models further in Moody’s upcoming special somment: SEC Approval of Market-Based Means to Value Stock Options Could Improve Valuations But At the Cost of Comparability of Earnings.  
20. There is one notable difference between the application of FAS123R for income statements and for proxy statement purposes. The amount of expense a company recognizes in the income statement will incorporate an estimate for expected forfeitures of service-based awards prior to vesting. This estimate will be trued-up and expense will be adjusted accordingly for a company’s actual forfeiture experience. However, when calculating the figures for the SCT, companies have to disregard any potential forfeitures and instead assume the service conditions will be achieved.
**Equity that vests if a market condition is met.** For these types of awards, the service period over which compensation expense is recognized is inferred from the model used to value the award. More complex valuation models, such as a lattice model or Monte Carlo simulation, generally must be used to value awards with market conditions. The amount recognized would not be changed even if the market condition was not achieved in the time estimated by the model.

**So-called “liability classified” awards:** Certain types of equity compensation awards, such as those that allow for cash settlement like a stock appreciation right (SAR), are required to be reported as liabilities on a company’s balance sheet. The fair value of these awards is remeasured at each reporting date through the settlement of the award (e.g., exercise date of a SAR). Liability classified awards can result in volatile compensation expense and can trigger positive or negative values. The cost expensed in the final year will ensure that the aggregate expense over the period from grant date reflects the actual outcome at settlement.

Some additional issues to consider:

- **If any terms of an award are modified after the grant date.** If the terms of a previously issued award are changed, incremental compensation cost will be recognized in an amount equal to excess fair value of the modified award over the fair value of the original award immediately before the modification. This compensation expense will be recognized over the remaining service period or immediately if the modified awards are fully vested.

- **If the executive is close to retirement eligibility.** If an executive is coming close to reaching eligibility for retirement and accelerated vesting is provided upon reaching retirement eligibility, the cost should be expensed over the period from grant date to date of retirement eligibility, regardless of whether there is a longer vesting schedule. For example, if a 53-year-old CEO is eligible for retirement at 55, any awards in that year should be expensed over two years and not in reference to a longer vesting schedule. These expenses are not reversed if the CEO stays with the company. This would have the effect of overstating the Statement 123R figure in the years running up to the year of eligibility. On the other hand, since the company has to expense immediately the full costs of any awards made after becoming eligible for retirement, the figures disclosed subsequently in the proxy statement SCT will match the grant date fair value in the grants of plan-based awards table.
Appendix Two: What’s in the CD&A?

The SEC requires the CD&A specifically requires discussion of:

- Objectives of executive pay plan
- What the compensation plan is designed to award (i.e., management behavior, company performance)
- Individual elements of company’s executive compensation plan (short term and long term)
- Reasons for board's decisions about amounts of payouts generated by each type of pay
- Commentary on how each type of pay fits into company's overall compensation goals

In addition, the SEC outlines a list of other areas that should be considered for inclusion in the CD&A if they are material to an investor’s understanding of the compensation program:

- Allocation of long-term and currently paid compensation
- Allocation of cash and non-cash compensation, and different forms of non-cash pay
- Basis for allocation of long-term pay linked to each different form of award
- Explanation of board decisions on long-term awards to executives (including equity)
- Corporate performance metrics driving compensation policies and payout decisions
- Structure of different types of pay implementation relating to company performance
- Company policies/decisions on adjustments/recovery of awards or payments
- Explanation of decisions on increasing/decreasing materially executive pay against board's previously stated intentions
- Realization of executive pay from prior compensation by explaining how different pay components (e.g., how gains from prior option or stock awards are considered in setting retirement benefits)
- Basis for choosing particular events to trigger payouts (e.g., reasoning behind using a single-event trigger due to a change in control)
- Effects of accounting and tax treatments of certain types of pay

21. The CD&A must discuss grant timing and how the board determined the price at which to exercise all equity awards, not just stock option awards.
Related Research

**Special Comment:**
- U.S. Directors May Have To Confront Investor Demands To Rethink Executive Pay January 2007 (101676)
- U.S. Executive Pay Structure and Metrics, June 2006 (97887)
- The Downside of Incentive Pay for Directors, April 2006 (97174)
- First Quarter Earnings—for the First Time—Fully Reflect the Cost of Share-Based Compensation Programs for All Companies, April 2006 (97330)
- CEO Compensation and Credit Risk, July 2005 (93592)

**Rating Methodology:**
- Analytical Implications of Employee Stock-Based Compensation, December 2002 (76852)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
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