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Lessons from the First Year of Pay vs. Performance Disclosures

As we approach the 2024 proxy season, companies are preparing for the second year of compliance with the pay vs. performance (PvP) disclosure required under Item 402(v) of Regulation S-K. As a reminder, under Item 402(v) of Regulation S-K:

Companies are required to provide tabular disclosure that compares pay reported in the Summary Compensation Table (SCT) for the principal executive officer and the average of other named executive officers (NEOs) to the compensation actually paid (CAP) to these executives, as well as comparisons to three performance metrics: total shareholder return (TSR), net income, and a company-selected measure that represents the most important metric used to link company performance and CAP.

In addition to this tabular disclosure, companies must include a “clear description” in narrative or graphical description (or a combination of both) of: (i) the relationship between each financial performance measure included in the table and the CAP (both for the principal executive officer and the average for the other NEOs) over the fiscal years required to be disclosed and (ii) the relationship between the company’s TSR and its peer group TSR as reflected in the table.

Companies are also required to provide a tabular list of at least three and up to seven financial performance measures that the company determines are its most important measures used to link CAP for the most recently completed fiscal year to performance; companies may also include nonfinancial measures

(such as environmental, social, and governance (ESG) goals or other non-financial objectives) if they are considered among the most important, so long as at least three of the measures are financial performance measures and the total number of performance measures (both financial and nonfinancial) does not exceed seven. If a company uses fewer than three financial performance measures to link compensation to performance, the table must list all such measures.

Lessons learned from year one of compliance with pay vs. performance disclosure

To assist companies updating their PvP disclosure for year two, there are lessons to be learned from market practice and comments from the Securities Exchange Commission (SEC) from year one.

Peer group for total shareholder return comparisons: the majority of companies are using the same industry index that is used in the Form 10-K total return chart

Under the PvP rules, the PvP table must include cumulative TSR comparisons for a company-selected peer group. The peer group must be either (1) the one used for the Form 10-K performance graph (other than broad market indices) or (2) one disclosed in the Compensation Discussion and Analysis (CD&A) that is used to help determine executive pay. In 2023, the majority of companies opted to select an index managed by a third party, relieving the company of the burden of footnoting additional TSR calculations for peer group changes.

Company-selected measures: the most common company-selected measures have been related to a form of profit or income

Under the PvP rules, companies are required to include a company-selected measure in the PvP table, which is defined as the most important financial measure in linking CAP to company performance in the most recently completed fiscal year. This measure cannot already appear in the table, and a company is permitted to omit if no such measure exists. Of the companies disclosing a company-selected measure in 2023, most company-selected measures were non-GAAP financial measures that are profit- and income-based (including earnings per share based financial measures; earnings before interest, taxes, depreciation, and amortization (EBITDA); and earnings before interest and taxes (EBIT)), while others used return-based metrics (including various types of return on income or return on investment). In 2023, most companies reported absolute numbers or ratios, likely as a result of the SEC's Compliance & Disclosure Interpretations (CD&Is) confirming that company-selected measures must be selected annually. Very few companies included supplemental columns with other measures in their PvP table.

Compensation actually paid: CAP tends to track with TSR and is more volatile than SCT pay

In 2023, almost a quarter of companies reported at least one negative CAP figure in their PvP table. CAP values are heavily influenced by stock price movements and, in the case of performance-based awards, the assumed or actual level of performance achievement. As a result, years where stock prices and/or performance expectations fall relative to the prior year can result in the reporting of potentially large negative figures. These negative values may not require much explanation; however, companies may wish to explain exceptionally high figures as representing compensation that has not yet been “earned” or “realized” by an executive where that is the case.

Tabular lists of important measures: most companies disclosed a single tabular list featuring three to five measures, and it was uncommon for companies to include non-financial measures

In addition to the company-selected measure, companies are required to include a tabular list of the three to seven most important measures in linking CAP to company performance during the year. (The first three most important measures must be financial in nature, and if a company has fewer than three, it must list all of them.) In 2023, most companies included three to five measures in their tabular list. Disclosures of non-financial measures appear to be limited, both in terms of the number of companies disclosing any such measures and the number disclosing more than one, with a large majority of companies only including financial measures in 2023. Where non-financial measures were included, they often related to ESG measures. Many companies are directing the reader to the CD&A for additional details on the measures included in their tabular lists instead of including supplementary disclosure in the PvP section of the proxy statement. In 2023, almost all companies included only a single tabular list, likely as a result of the fact that the “most important” measures as defined in the rule will be those used in equity-based incentive plans, which are generally consistent across all NEOs.

Location and types of disclosure: almost all companies are including the PvP section alongside the CEO pay ratio following the compensation tables and utilizing graphs to illustrate the relationships

Under the PvP rules, companies are allowed to choose where in their proxy statement to include the PvP disclosure and are provided flexibility in how to explain the relationship between the CAP and performance columns of the PvP table. In 2023, most companies included their PvP disclosure as a standalone item in the proxy statement, typically located near the CEO pay ratio disclosure. In addition, most companies elected to use graphical illustrations of the relationship between CAP performance and the performance measures in the PvP table. A small number of companies chose to also include SCT pay in these charts to show how SCT pay differs from CAP. In 2023, very few companies relied solely on narrative disclosure without graphics to assist.

CAP footnotes and equity valuation assumptions: most companies are providing a detailed reconciliation from SCT pay to CAP but many are not including detailed equity valuation assumptions

Under the PvP rules, companies are required to include footnotes discussing adjustments from SCT to CAP, including equity component adjustments and equity valuation assumptions that differ materially from those at the date of grant. In 2023, most companies provided a full reconciliation of the SCT to CAP adjustments, inclusive of the component equity adjustments (i.e., the required equity calculations in 402(v)(2)(iii)(C)(1)(i)-(iv)), in either tabular or narrative footnotes. However, very few companies provided any details on the equity valuation assumptions (despite the fact that the rule states that “for the value of equity awards added pursuant to paragraph (v)(2)(iii)(C) of this section, disclose in a footnote to the table required by paragraph (v)(1) of this section any assumption made in the valuation that differs materially from those disclosed as of the grant date of such equity awards.” In 2023, most companies simply stated that measurement date fair values required for PvP purposes were calculated in a manner consistent with those for grant date purposes (a requirement under paragraph (v)(C)(3)), with some companies cross-referencing to the Form 10-K grant date valuation assumptions.

SEC comments

In 2023, some of the most common issues in PvP disclosure that the SEC identified in comment letters include:

Missing required elements of the disclosure, such as a description of the relationships between CAP and the metrics or the list of three to seven financial performance measures used to link CAP with company performance

Including multiple company-selected measures, or not including the company-selected measure in the tabular list of three to seven most important financial performance measures

Failing to provide a reconciliation of non-GAAP measures selected as the company-selected measure against the most directly comparable GAAP financial measure

Using a TSR peer group that does not match either the industry group used for the Form 10-K performance graph or the compensation peer group disclosed in the CD&A

Incorrect footnote descriptions to the table that suggest misinterpretation of the rules

Failure to include or identify all NEOs who served at any point in each year in the table

Using partial compensation received for the year for individuals in the table (i.e., if an individual is promoted to a NEO role during the year, only including compensation earned for the period served as an NEO)

Footnotes indicating a “year-over-year” change in fair value for awards that should be valued as of the date of vesting, rather than at year end

Practical tips for preparation of 2024 pay vs. performance disclosure

1. Disclosure of NEOs must include all individuals who were NEOs at any time during the covered fiscal year

Where a company has multiple principal financial officers during a single covered fiscal year, each NEO must be included individually in the calculation of average compensation amounts. Former NEOs (i.e., individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year) should also be included in the calculation.

2. Companies may specifically designate only one financial performance measure as the company-selected measure

Under the PvP rules, companies must include in the PvP table for each covered fiscal year their TSR, net income and an additional financial performance measure which in the company’s assessment represents its most important financial performance measure used to link CAP to its NEOs to a company-specific measure. Companies may provide additional financial performance measures in the PvP table, but such additional measures should be identified as “supplemental” in either the table or footnotes.

3. The use of a custom peer group in a subsequent PvP table requires calculating peer group TSR for all fiscal years presented using the most recent fiscal year peer group

The PvP rules require companies to disclose their peer group cumulative TSR, with the “peer group” being either (i) the published industry or line-of-business index used for purposes of the stock performance graph included in either (a) its “glossy” annual report or (b) its annual report on Form 10-K or (ii) the companies it uses as a peer group for purposes of its CD&A. If a company decides to use the CD&A peer group (instead of the peer group used for the performance graph) to report peer group cumulative TSR, it must use the peer group being disclosed in its current proxy statement as the peer group for each of the fiscal years covered in the PvP table.

4. Outside of limited exceptions, when a company changes the composition of its custom peer group in a subsequent PvP table, this requires a comparison of company TSR to both the new and former peer groups

The PvP rules require companies that use a different peer group from the peer group used in the prior fiscal year (i.e., when a company adds or removes a company from the peer group year to year) to explain, via footnote, the reason or reasons for the change and to compare the company's cumulative TSR with the cumulative TSR of both the new peer group and the former peer group. SEC staff have indicated that there are two situations where a comparison between the new and former peer group is not required: (i) when a company is omitted from the peer group solely because it is no longer in the industry or line-of-business or (ii) when the changes in peer group composition are the result of the application of pre-established objective criteria (such as where the company has consummated a merger or other acquisition). In each of these situations, the company must disclose the specific description of, and the bases for, the change, as well as the identities of the companies removed from the peer group.

5. Companies may omit confidential information when disclosing material changes in assumptions in calculating CAP

The PvP rules provide that, when calculating CAP, if in determining an equity award's "fair value" any assumption made in the valuation differs materially from that disclosed as of the grant date of such equity award, the company must disclose the assumption in a footnote to the PvP table. If satisfying this disclosure would involve disclosing confidential information (such as when the probable outcome has changed from one fiscal year to the next), the disclosure of which would result in competitive harm to the company, the company may omit such confidential information. However, in such situations, the company must be as transparent in its disclosure as possible without disclosing the confidential information, such as giving a range of outcomes or discussing how the performance condition impacted the "fair value" determination.

6. Companies may limit their reconciliation tables to the most recently completed fiscal year for PvP tables following their initial table in year one of compliance with the PvP disclosure requirements

When calculating CAP for the principal executive officer and other NEOs, the PvP rules require companies to disclose in footnotes to the PvP table each of the amounts deducted and added pursuant to the rules to arrive at the appropriate CAP amounts for each covered fiscal year. SEC staff have indicated that it is permissible to limit such information to the most recent fiscal year unless the information for prior fiscal years is material to an investor's understanding of the information reported for the most recent fiscal year or the required relationship disclosure comparing CAP and the various financial performance measures included in the table.

Contact us

Husch Blackwell's Securities & Corporate Governance team will continue to monitor implementation of the SEC's PvP rules. Should you have any questions, please do not hesitate to contact Craig Adoor, Steven Barrett, Robert Joseph, Victoria Sitz, Andrew Spector, or your Husch Blackwell attorney.