RE: Comments on Pay Versus Performance Section 953a

I am an Assistant Professor of Accounting at the University of Colorado Leeds School of Business. A focus of my research is evaluating how disclosures in the Proxy Statement shape evaluation of compensation by investors and related parties (e.g., Proxy Advisors).

In considering the new proposed disclosure of a table of actually paid compensation (compensation paid table), it is important to consider two questions. Why might the information in the summary compensation table (SCT) present and incomplete or misleading view of compensation to investors? Does the additional proposed disclosure address these concerns?

To consider when situations might arise, it is important to evaluate the reasons that compensation actually paid would deviate from compensation reported in the SCT. In general, there should be limited, if any, deviations for cash compensation in the compensation paid table compared to the SCT because cash is reported at the value paid in the SCT.

Thus, meaningful deviations between compensation as reported in the SCT and the compensation paid table will likely result from equity compensation. Specifically, the SCT reports the grant date fair value of equity granted during the year whereas the new table would report equity payouts during the year. Thus, the compensation actually paid table may provide substantially new information relative to the SCT for equity compensation.

Below I propose three situations in which I expect data for equity in the paid compensation table would differ substantially from data in the SCT – and thus situations in which the compensation paid table is likely to be perceived to contain significant new information. I then provide recommendations of additional information that would help financial statement users understand these differences. Many of these situations arise at least in part from the fact that equity is generally seen as a long-term form of compensation. Thus, it is difficult to force it into an annual reporting framework or easily relate equity values to performance in a single year.

1. **Lumpy option exercises or vesting schedules:** While stock and option grants tend to be evenly spread out across years (i.e., firms tend to grant about the same number of shares or options per year), executives may not receive equity payouts in as consistent a manner. For example, an executive may choose to exercise a large number of options from several years of grants within a single year. Much of this behavior could be unrelated to firm performance (e.g., personal liquidity needs and portfolio rebalancing), so there is no clear means through which additional performance disclosure is likely to clarify this issue. Displaying multiple years of compensation paid data in the new table would enable users to identify a particular year as an outlier but not the underlying causes.[1]
2. **Stock Price Performance for Options:** In the SCT, options are reported at their grant date fair value as determined by an allowable model (e.g., Black-Scholes). Stock options are commonly granted at-the-money (i.e., strike price = price at time of grant) with a 10 year-life. The value for options exercised as reported in the compensation paid table is

[1] Other required data in the Proxy does allows investors to view the number of shares vested and options exercised in the "Option Exercises and Stock Vested" table. But this Table only presents a single year of data so it is not possible to assess whether the vesting/exercises were abnormal without referring to prior Proxy Statements.

based on the difference between the stock price at the time of exercise compared to the strike price. Since stock options are on average exercised about 6 to 7 years after grant date[2], this value will be driven by stock performance over this time period. Current year TSR is only a small part of the story, and is, in fact, not relevant for options that were exercised near the beginning of the year. Multiple years of stock price performance is also generally relevant to stock awards because such awards often include multiple year vesting periods, but deviations are unlikely to be as substantial as options.

3. **Number of Shares Earned for Performance Vested Equity Payouts:** Performance-vested equity awards are equity awards for which the ultimate number of shares paid to the executive depends on some measure of firm performance (e.g., relative TSR, EPS) over a defined "performance period," most commonly 3 years. These awards are reported at their grant date fair value in the SCT at the time of initial grant (i.e., at the beginning of the "performance period"). For many-awards, the grant date fair value is calculated by multiplying share price on grant date by the "target" number of shares in the award, thus assuming that the target is on average the number of shares that will be paid. Even when other methods are used to calculate grant date fair value, the valuation tends be close to the target-based valuation described above.

   In contrast, the compensation paid table will include information about the number of shares that were actually paid for the award based on actual performance relative to predetermined performance targets after the end of the "performance period". For a sample of S&P 500 firms, my research shows that payouts average 115% of target levels, suggesting that grant date valuations are on average understating the value of these awards (Pawliczek, 2021, attached). In this case, investors could gain substantial value from understanding compensation paid compared to the information in the SCT. For example, a high value would be reported in the compensation paid table if for the award vesting that year the executive earned a maximum payout equal to 200% of the target number of shares. But, to understand the influence of performance-vested equity payouts, it is essential to understand performance for the specific metrics used in the award. Complicating such assessment, the performance metrics used within these awards are frequently non-GAAP metrics unique to the award (e.g., the non-GAAP earnings as defined in the award may have different exclusions from the non-GAAP earnings reported in the earnings announcement).

Recommendation 1: Recommend or require that companies provide guidance on the "vintage" of the equity that is included in the compensation paid table or a relevant performance period.

Equity awards are generally considered an aspect of long-term compensation. Thus, any annual measure of performance provides an incomplete picture of the relevant performance to the specific equity payout. Moreover, the time period that is most relevant is likely to vary across firms and within firm over time. For example, does the data reported in the compensation paid table represent options that were granted 6 years ago or restricted stock granted two years ago? Thus, simply providing 3 to 5 years of TSR or other performance metrics without guidance requires the user to seek out information elsewhere to determine the relevant time period (e.g.,

[2] Firms report the average option life based on prior exercise behavior as one of the assumptions used to value stock options. These assumptions are generally reported in 10K.

determine vesting period by reading prior proxy statements). Providing either a summary (average equity age) or a list of awards and grant date that were paid during the year would help clarify. Alternatively, companies could specify the most relevant time period.

Recommendation 2: Allow companies to provide additional years of performance data within the table if deemed relevant.
For companies providing significant option grants or imposing long vesting periods, even three to five years of data may provide insufficient data to understand the firm performance that generated the reported value of equity payouts.

Recommendation 3: Require that any metrics used to determine a significant portion of the payout for performance-vested equity awards – and how these metrics compare to target levels in the award.
As highlighted in (3) above, the payouts to performance vested equity awards could represent a valuable source of new information to allow investors to judge if payouts higher than target were justified.[3] But to make this assessment, investors need to understand performance along the specific metric(s) used to calculate payouts in the award – and how the realized values compared to the targets in the award. Placing the information about metrics near the reported values of traditional financial metrics that are proposed would also help investors to evaluate the appropriateness of these metrics in assessing firm performance (e.g., if performance for the metric increased and exceeded target for the past three years while income and TSR were negative).

Sincerely,
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Attachments: Pawliczek, A., 2021. Performance-vesting share award outcomes and CEO incentives. *The Accounting Review*, *96*(5), pp.337-364.

[3] Payouts to performance vested equity are generally reported in the narrative portion of the CD&A section.