Deloitte.

September 10, 2015
Volume 22, Issue 31

Heads Up

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SEC Issues Final Rule on Pay Ratio Disclosure

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The SEC recently issued a final rule[1] on pay ratio disclosure in response to a mandate in Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Registrants must adopt the final rule for their first fiscal year beginning on or after January 1, 2017.

Scope and Exemptions

Under the final rule, a registrant must annually disclose (1) the median of the annual total compensation of all its employees (excluding the individual that the SEC describes as the principal executive officer (PEO) and that is referred to herein as the chief executive officer (CEO)), (2) the annual total compensation of its CEO, and (3) the ratio of the median of the annual total compensation of all its employees to the annual total compensation of its CEO.

Example

If the median annual total compensation of a registrant's employees is $50,000 and the annual total compensation of its CEO is $2,500,000, the CEO's compensation is 50 times larger than the median employee's compensation.

The pay ratio may be described numerically either as 50 to 1 or 50:1 or narratively (e.g., "the PEO's annual total compensation is 50 times that of the median of the annual total compensation of all employees").

The final rule adds paragraph (u) to Regulation S-K, Item 402,[2] and requires registrants to disclose their pay ratio in any filing described in Regulation S-K, Item 10(a),[3] for which executive compensation disclosure is required under Item 402 (e.g., an annual report on Form 10-K, registration statement under the Securities Act and Exchange Act, proxy and information statement).[4] However, the disclosure requirement does not apply to emerging growth companies, smaller reporting companies, foreign private issuers, or U.S.–Canadian multijurisdictional disclosure system filers.

Definition of "Employee" Under the Rule

The final rule's definition of "employee" encompasses all "full-time, part-time, seasonal, and temporary employees employed by the registrant or any of its consolidated subsidiaries." Independent contractors or "leased" workers that provide services to a registrant or its consolidated subsidiaries, and whose compensation is determined by an unaffiliated third party, are not considered employees and must be excluded from a registrant's identification of its median employee.

1 SEC Final Rule Release No. 33-9877, *Pay Ratio Disclosure*.
2 SEC Regulation S-K, Item 402, "Executive Compensation."
3 SEC Regulation S-K, Item 10(a), "Application of Regulation S-K."
4 As with other Item 402 information, the final rule treats the pay ratio disclosure as "filed" for purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934. Therefore, the disclosure is subject to potential liability (e.g., for making misleading statements under Section 18 of the Exchange Act).

Editor's Note: Employees hired as contractors and not employed by a third party appear to be part of the population a registrant uses to determine its median employee. This could be an unintended result of the rulemaking, and the SEC may need to release additional guidance to clarify this point.

The proposed rule defined an employee as an individual employed on the last day of the fiscal year; however, the final rule defines an "employee" as an individual employed on any date of the registrant's choosing within the last three months of the registrant's last completed fiscal year. Registrants must disclose the date used to identify the median employee but not the rationale for selecting that particular date.

Editor's Note: The three-month rule may make it easier for employers to identify the median employee by eliminating part-time and seasonal employees hired in the fourth quarter of the fiscal year.

Although the final rule defines "employee" as a registrant's U.S. and non-U.S. employees, the SEC provides two exemptions from this definition to alleviate potential difficulties associated with collecting global compensation data.

Data Privacy Exemption

The final rule's definition of "employee" does not apply to workers in foreign jurisdictions in which a registrant cannot obtain the compensation data it needs to comply with the rule without violating local data privacy laws.

To qualify for this exemption, a registrant must first make "reasonable efforts" to collect the required compensation data. The rule states that such efforts would entail seeking an exemption under the applicable jurisdiction's data privacy laws and using that exemption if it is granted. Registrants that use the data privacy exemption also must:

- Disclose each jurisdiction that was excluded.
- Identify the specific data privacy laws or regulations for each jurisdiction and explain how complying with the final rule violates such laws or regulations.
- Note any efforts to obtain an exemption under the data privacy laws.
- Exclude all non-U.S. employees in any jurisdiction in which the exemption is used (i.e., registrants cannot choose to exclude only a subset of that jurisdiction's employees from the definition of employee).
- Disclose the estimated number of employees from each jurisdiction that have been exempted as a result of data privacy laws.
- Obtain and file as an exhibit a legal opinion on the registrant's inability to collect the compensation data necessary to comply with the final rule without violating the jurisdiction's data privacy laws.

De Minimis Exemption

The final rule also contains a de minimis exemption for non-U.S. employees. To apply this exemption, a registrant must have a non-U.S. employee workforce that makes up 5 percent or less of the total employee population. Such a registrant may choose to exclude all of those non-U.S. employees when determining the median employee but is not permitted to exclude only a portion of its non-U.S. workforce. If more than 5 percent of a registrant's workforce is composed of non-U.S. employees, the

registrant may exclude up to 5 percent of these employees; however, it must exclude all employees located in a particular jurisdiction (i.e., it cannot exclude a subset of employees from one jurisdiction and employees from other jurisdictions to arrive at the 5 percent threshold).

A registrant using the de minimis exemption must disclose:

- The jurisdiction(s) of the excluded employees.
- The approximate number of employees excluded from each jurisdiction.
- The total number of its U.S. and non-U.S. employees before any exemption (data privacy or de minimis) is used.
- The total number of U.S. and non-U.S. employees used for its de minimis calculation.

Non-U.S. employees excluded from the determination of the median employee under the data privacy exemption count against the 5 percent de minimis threshold. Although a registrant may exclude any non-U.S. employee that meets the data privacy exemption, if the number of excluded employees under the data privacy exemption equals or exceeds 5 percent of total employees, the registrant may not use the de minimis exemption to exclude additional employees.

Editor's Note: Although registrants can exclude up to 5 percent of their non-U.S. employees, they are still required to track and disclose the number of total employees that reside outside of the United States.

Furthermore, if 5 percent or more of a registrant's non-U.S. workforce is located in a single country, it would not be able to exclude *any* of these employees from its median employee determination. This is because the final rule states that registrants must exclude all employees from the same jurisdiction, and excluding all of the employees from that country would violate the 5 percent de minimis cap.

Identifying the Median Employee and Calculating Annual Total Compensation

Identifying the Median Employee

The final rule requires registrants to identify the median employee whose compensation will be used for the annual pay ratio calculation only once every three years unless there has been a change in the registrant's employee population or compensation arrangements that it reasonably believes would result in a significant change to its pay ratio disclosure. If the registrant believes that there have been no such changes, it must disclose that it is using the same median employee in its pay ratio calculation and briefly describe the basis for its reasonable belief. The rule states that if significant changes in the median employee's circumstances have occurred (e.g., the employee is no longer employed in year two or three or is promoted to a much higher-paying job), "the registrant may use another employee whose compensation is substantially similar to the original median employee based on the compensation measure used to select the original median employee."

Editor's Note: Many registrants may view this accommodation as a welcome change from the proposed rule, which would have required that the median employee be identified every year. If the same (or a similarly situated) employee is used, changes in the pay ratio from year to year will reflect changes in annual total compensation instead of changes in the identified median employee.

Under the final rule, registrants may make cost-of living adjustments to the compensation of employees that reside in a jurisdiction different from that of the CEO provided that these adjustments are applied to all such employees included in the calculation. If the median employee does not reside in the CEO's jurisdiction, any cost-of-living adjustments applied to identify the median employee also must be applied to the median employee's annual total compensation.

The final rule requires registrants to describe the cost-of-living adjustments used to identify the median employee and to calculate the median employee's annual total compensation. Registrants must also disclose (1) the measure used as the basis for the cost-of-living adjustment (e.g., a purchasing power parity conversion factor), (2) the jurisdiction in which the median employee resides, and (3) the median employee's annual total compensation and pay ratio without any cost-of-living adjustments.

Editor's Note: Registrants that choose to apply cost-of-living adjustments will substantially increase the effort they need to make to determine the "median employee." This disclosure requirement precludes a registrant from assuming that the same individual would represent the "median employee" in both adjusted and unadjusted terms. Rather, the registrant must identify two separate median employees — one calculated by using cost-of-living adjustments, the other by using nonadjusted compensation.

Although a registrant must disclose both the adjusted and unadjusted pay ratios in its filings, the SEC will consider the cost-of-living-adjusted ratio the "official" pay ratio.

Flexibility in Choice of Method

The final rule grants a registrant flexibility to choose a method to identify the median employee on the basis of its own facts and circumstances. The registrant must describe the method it chooses, including any material assumptions, adjustments (such as cost-of-living or foreign exchange rates), or estimates. The SEC also provides further guidance on statistical sampling, compensation measures, and the actual employee chosen, as explained below.

Editor's Note: It is important for registrants to thoroughly document all of the steps taken and assumptions made in identifying the median employee, so that they can (1) clearly describe their method in the pay ratio disclosure and (2) repeat the process in the future.

Use of Statistical Sampling

The final rule allows registrants to use statistical sampling when identifying the median employee. The SEC believes that each registrant must determine which method is appropriate on the basis of its facts and circumstances. Hence, the final rule does not provide specific parameters, such as sample size and confidence intervals. However, the final rule cites an analysis discussed in the proposed rule that indicated that:

- Under the assumptions used in the analysis, the appropriate sample size for a registrant with a single business line or geographical unit varied between 81 and 1,065 employees, with an average of 560, depending on the industry.
- More than one statistical sampling approach may be used for businesses with multiple business lines or geographical units.

- In identifying the median employee, a registrant does not need to calculate the exact compensation amounts for every employee. For example, the registrant may not need to determine exact compensation for employees that have extremely high or low compensation that would clearly fall above or below the median employee compensation.

For many registrants, determining an appropriate random sample of employees will be the most challenging aspect of complying with the final rule. In the initial year of adoption, the determination is likely to be an iterative process.

Editor's Note: A statistically valid random sample of the workforce should take into account various factors, including the distribution of compensation data throughout the organization (e.g., a registrant with a wider distribution is likely to need a larger sample size than an organization with a narrower distribution). Registrants should also consider other factors, including:

- Number of employees (full-time, part-time, seasonal, and temporary).
- Geographies.
- Lines of business.
- Payroll systems.
- Stratification of pay levels across the workforce.
- Types of compensation the employees receive.

The population should include all U.S.-based and non-U.S.-based full-time, part-time, seasonal, and temporary employees who were employed on the date chosen by the registrant. Presumably, most registrants will want to simplify the process by taking full advantage of the data privacy and de minimis exemptions before defining the population to be sampled. Independent contractors and temporary workers employed by a third party should not be included in the population.

Determining Annual Total Compensation to Identify the Median Employee

The final rule allows a registrant, when determining the median employee, to use any compensation measure that is consistently applied to all employees in the calculation as long as the chosen measure is disclosed. The SEC makes it clear that this flexibility in choosing a compensation measure is only for *identifying* the median employee. The actual value disclosed in the proxy must be calculated in accordance with Regulation S-K, Item 402(c)(2)(x) (i.e., the "summary compensation table" value).

For many registrants that do not extend incentive compensation throughout the organization, base salary or wages plus overtime may be the most appropriate measure of compensation to use to identify the median employee. For registrants whose annual cash incentives do extend throughout the organization, annual total cash compensation might be the most representative measure of compensation.

Total compensation used to identify the median employee does not have to coincide with the end of the registrant's fiscal year. Therefore, an alternative approach might be to use tax or payroll information (e.g., a W-2 or non-U.S. equivalent).

Calculating Annual Total Compensation Used in the Pay Ratio

Once the median employee has been identified, registrants must gather relevant compensation data and make necessary assumptions to calculate the annual total compensation for the median employee and CEO in accordance with Regulation S-K, Item 402(c)(2)(x) (i.e., the "summary compensation table" values). If the registrant provides benefits such as health care, bus passes, housing, and employee

discounts, it may include these elements in the median employee's annual total compensation. Each registrant will need to determine whether to include such "personal benefits" and perquisites in the calculation of the median employee's annual total compensation (e.g., a registrant may want to include them because their inclusion should improve the pay ratio). However, if they are included in the median employee's annual total compensation, the registrant would also be required to include these items in the calculation of the CEO's annual total compensation.

Editor's Note: Adding health care benefits to the median employee's and CEO's total annual compensation could have a fairly meaningful impact on the pay ratio, as shown in the table below:

	CEO	Median Employee	Pay Ratio
Total annual compensation	$4,200,000	$42,000	100:1
Employer-paid health care	$12,000	$12,000	—
Total annual compensation + employer-paid health care	$4,212,000	$54,000	78:1

The final rule permits a registrant to use reasonable assumptions (e.g., in calculating the change in the actuarial present value of an employee's defined pension benefit under a multiemployer pension plan) in estimating the annual total compensation. In addition, the final rule excludes government-mandated pensions and other benefits from annual total compensation, even if the employer funds those benefits through social taxes.

Under the final rule, there are two methods of calculating annual total compensation when a CEO is hired mid-year:

- Combining the total compensation of each person who served as CEO during the year.[5]
- Annualizing the compensation of the CEO in place on the date the registrant selects to identify the median employee.

In either case, the registrant must disclose the method it used to calculate the CEO's annual total compensation.

Disclosure of Methods, Assumptions, and Estimates

As noted previously, the final rule does not prescribe the method a registrant must use to identify the median employee or calculate annual total compensation; however, registrants must apply the methods they choose consistently and explain them in a brief disclosure. This disclosure must sufficiently explain the appropriateness of the methods, as well as the estimates, material assumptions, and adjustments used, but it need not include technical details, such as formulas, confidence intervals, or exact steps followed.

Under the final rule, registrants must also disclose any significant changes in their methods, assumptions, adjustments, or estimates from one year to the next.

[5] Calculated in accordance with Regulation S-K, Item 402(c)(2)(x) (i.e., the "summary compensation table" values), and reflected in the summary compensation table that is also required by that regulation.

Editor's Note: We expect that during the first year or two after adoption, some registrants may change their methods of computing the pay ratio as they find more efficient and accurate ways to identify the median employee and calculate annual total compensation.

Once registrants find a method that works for them, however, they are advised to stick with it. Some shareholders, analysts, or other parties may view frequent method changes as a red flag, thereby drawing unwarranted attention to a registrant's pay ratio disclosure.

Meaning of "Annual"

Under the final rule, annual total compensation for the median employee and CEO is total compensation for the registrant's last completed fiscal year. The use of any other annual periods, such as the year before the registrant's last completed fiscal year or the period used for tax or payroll records, is not allowed.

Editor's Note: Although the final rule allows registrants to choose the compensation measure and time frame used to identify the median employee, the annual total compensation amount to be used in the pay ratio disclosure is well defined and is determined in a manner consistent with that specified in the rules governing the preparation of the summary compensation table disclosure required by Regulation S-K.

Timing and Transition

Updating Pay Ratio Disclosure for the Last Completed Fiscal Year

Registrants are not required to disclose the pay ratio for the last completed fiscal year until they file their Form 10-K or proxy statement, whichever is later. In either case, registrants must disclose their pay ratio no later than 120 days after the end of the fiscal year. [6]

Initial Compliance Date and Transition Periods

The final rule indicates that registrants' first reporting period under the final rule is their first full fiscal year beginning on or after January 1, 2017.

As with the transition period for existing registrants, a new registrant's initial pay ratio disclosure must follow its first full fiscal year beginning after the registrant has (1) been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act (i.e., it is a "reporting company") for a period of at least 12 calendar months beginning on or after January 1, 2017, and (2) filed at least one proxy statement that does not contain the pay ratio disclosure. The final rule does not require registrants to disclose the pay ratio in a registration statement for an initial public offering.

A registrant that ceases to be a smaller reporting company or an emerging growth company will not be required to provide the pay ratio disclosure until its first full fiscal year that begins after exiting such status; however, no disclosure is required for any fiscal year commencing before January 1, 2017.

[6] Under the final rule, when a registrant is relying on Instruction 1 of Items 402(c)(2)(iii) and (iv) of Regulation S-K to omit the salary or bonus of the CEO because it is not calculable until a later date, the registrant may also omit the pay ratio disclosure until the salary or bonus component of its CEO's total compensation is determined. In such cases, the registrant must disclose (1) that the pay ratio is not calculable until the CEO's salary or bonus is determined and (2) the date on which the CEO's actual total compensation is expected to be determined.

Registrants that merge with or acquire another company are not required to include the employees of the acquired entity in the calculation of the median employee until the first full fiscal year after the merger or acquisition.

Editor's Note: A registrant with a fiscal year that ends on December 31 must provide its initial pay ratio disclosure (computed by using 2017 compensation totals) in its 2018 proxy statement.

Such a registrant should use the intervening two-plus years to inventory the countries in which its employees are located, identify how many payroll systems are used, and determine the types of compensation its employees receive. If a registrant expects to use a statistical sample of its employees to identify the median employee, it should consider establishing its sampling methods early on, tailored to its current employee population, because the process of determining the pay ratio for the initial year of adoption may be iterative and potentially quite complex for some.

Permissibility of Providing Additional Information

Registrants may present additional ratios or other information to supplement the required ratio. For example, some registrants may want to disclose the pay ratio based solely on U.S. employees or salaried employees in addition to the required pay ratio. However, the final rule states that registrants that choose to provide such additional information must ensure that it is "clearly identified, not misleading, and not presented with greater prominence than the required ratio."

Editor's Note: Registrants may determine that disclosing additional pay ratios (e.g., based on the U.S. employee population only or full-time employees only) provides valuable additional context to their shareholders. We suggest that registrants disclose additional pay ratios only if they expect to continue to disclose the additional information in the future. Further, we recommend that registrants, before providing such disclosures, consider whether the supplemental pay ratios help explain their pay decisions to shareholders or whether the additional disclosures could result in an unintended reaction from shareholders, analysts, or other parties.

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