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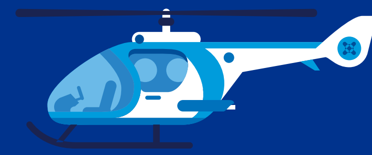

Defining Issues®

SEC adopts interpretive guidance on pay ratio disclosures

October 3, 2017

KPMG reports on interpretive guidance[1] issued by the SEC to help registrants prepare their 2018 required pay ratio disclosures.

Applicability

SEC registrants, excluding smaller reporting companies, emerging growth companies, foreign private issuers, Multijurisdictional Disclosure System (MJDS) filers and registered investment companies.

Key facts and impacts

The SEC adopted a rule in 2015[2] mandated by the Dodd-Frank Act that requires companies to disclose the ratio of the primary executive officer's compensation to the median compensation of all employees.

KPMG's *Defining Issues*, SEC Requires Pay Ratio Disclosure, summarizes the 2015 rule and its required disclosures.

Recently the SEC issued guidance to help registrants comply with the pay ratio disclosure rule, which is effective for fiscal years beginning on or after January 1, 2017.

The guidance addresses:

— reasonable estimates, assumptions and methodologies to prepare the disclosures;
— internal records to determine if the 5 percent de minimis exemption is available for non-US employees;
— internal records to determine the annual compensation used to identify the median employee; and
— how to determine what constitutes an employee.

Additionally, the SEC's Division of Corporation Finance's questions and answers address:

— the combination of reasonable estimates with statistical sampling or other reasonable methodologies;
— examples of sampling methods;
— when reasonable estimates may be used;
— examples of reasonable methodologies; and
— examples that show how reasonable estimates, statistical sampling and other reasonable methods can be used.

1 Commission Guidance on Pay Ratio Disclosure, Release Nos. 33-10415 and 34-81673; and Division of Corporation Finance Guidance on Calculation of Pay Ratio Disclosure, September 21, 2017

2 Pay Ratio Disclosure, Release Nos. 33-9877 and 34-75610, August 5, 2015

SEC interpretive guidance

Concept from rule	Guidance
Reasonable estimates, assumptions and/or methodologies may be used to determine the **median employee and annual total compensation**.	If a registrant uses reasonable estimates, assumptions and/or methodologies, the pay ratio and related disclosures would not provide a basis for SEC enforcement action unless the disclosures were made or reaffirmed without a reasonable basis or not provided in good faith.
Non-US employees may be excluded from the determination of annual total compensation of all employees if they account for 5 percent or less of total employees.	A registrant may use existing internal records, such as tax or payroll records, to determine whether the 5 percent de minimis exemption for non-US employees is available.
The **median employee** may be identified using a consistently applied compensation measure.	A registrant may use existing internal records, such as tax or payroll records, to identify its median employee, even if those records do not include every element of compensation, such as equity awards. If the identified median employee has unusual compensation that has a significant higher or lower effect on the pay ratio, the registrant may substitute another employee with substantially similar compensation based on the compensation measure (tax or payroll records) it used to select the original median employee.
An **independent contractor** is not considered an employee for purposes of determining annual total compensation of all employees.	A registrant may apply a widely recognized test under another area of law that the registrant uses (e.g. employment law or tax purposes) to determine whether its workers are employees.

Division of Corporation Finance's additional guidance

Question	Answer
May a registrant **combine reasonable estimates with statistical sampling or other reasonable methods** to determine the group of employees from which the median employee is identified?	Yes. A registrant may also use its employee population for this purpose.

Question	Answer
May a registrant use a **combination of sampling methods** to determine the group of employees from which the median employee is identified?	Yes. Examples, either alone or in combination, include: — simple, random sampling (drawing at random a certain number or percentage from the employee population); — stratified sampling (dividing the employee population into strata and sampling within each strata); — cluster sampling (dividing the employee population into clusters based on some criterion, drawing a subset of clusters and sampling observations within appropriately selected clusters); and — systematic sampling (drawn at a random starting point and a fixed sampling interval - i.e. every nth employee is drawn from a list sorted on the basis of some criterion).
When may **reasonable estimates** be used and what are some examples?	Examples include: — analyzing the composition of the company's workforce; — characterizing the statistical distribution of compensation of the company's employees and its parameters; — calculating a consistent measure of compensation and annual total compensation or elements of the annual total compensation of the median employee; — evaluating the likelihood of significant changes in employee compensation from year to year; — identifying the median employee; — identifying multiple employees around the middle of the compensation spectrum; and — using the mid-point of a compensation range to estimate compensation.
May a registrant use a **combination of reasonable estimates, statistical sampling and other reasonable methods** to determine the group of employees from which the median employee is identified?	Yes. Examples include, but are not limited to: — one or more distributional assumptions, if a registrant has determined that the assumption is appropriate given its own compensation distributions; — reasonable methods of imputing or correcting missing values; and — reasonable methods of addressing extreme observations, such as outliers.

A company must disclose changes in the method, or material assumptions, adjustments or estimates it uses to determine the median employee, or changes in how it calculates the median employee's annual total compensation, if the effects are significant.

The additional guidance from the Division of Corporation Finance also provides hypothetical examples showing how three registrants could use reasonable estimates, statistical sampling and other reasonable methods to identify their median employee. The types of registrants in the examples are:

- Company A has employees in and outside of the United States within three business units and 21 geographic units, covered by multiple payroll systems;
- Company B has a global workforce with employees concentrated in four geographic areas: North America, China, Europe and Latin America; and
- Company C has employees in the United States and Asia.

KPMG observation

The pay ratio disclosure requirement gives registrants a significant level of flexibility based on their own facts and circumstances that they can use to determine their pay ratio. Registrants are allowed to use operational data and other readily available information to help them prepare the disclosures. They should consider the interpretive guidance as they finalize their approach to preparing the disclosures.

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KPMG's Financial Reporting View

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