



Financial Reporting

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Material discussed in this *Financial Reporting* letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

Executive and Director Compensation Disclosure Rules

Executive Summary

On August 11, 2006, the SEC published new rules regarding executive and director compensation disclosure. The purpose of the rules is to adequately inform investors about *all* components of executive and director compensation – not to require any particular practice or regulate the amounts. The Commission believes it is the responsibility of compensation committees to determine executive compensation, the SEC to regulate disclosures regarding that compensation, and investors to determine how that information will be used.

The new SEC rules:

- Change the “named executives” captured in the Summary Compensation Table;
- Introduce a principles-based analysis of the company’s compensation policy, the Compensation Discussion and Analysis (CD&A);
- Modify the Compensation Committee Report to complement the CD&A;
- Revise and expand compensation disclosures to include a “total compensation” column in the Summary Compensation Table, a supplemental grants award table including both cash and equity awards, and narrative disclosures to provide context and explanations for the tables;
- Create new tables for equity awards outstanding at year end and equity awards activity – options exercised and stock vested – during the year;
- Add post-employment compensation tables for retirement and nonqualified deferred compensation and disclosures for other postemployment payments payable at termination or change in control; and
- Introduce a Director Compensation Table.

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The disclosures serve many – and varied – purposes. Some disclosures address activity during the fiscal year (e.g., summary compensation table or equity award activity). Others address obligations or valuations as of a point in time (e.g., pension benefit obligations or equity awards outstanding as of fiscal year end). And depending on the table, the required information may be reflected on an "as earned," "as granted," or "as paid" basis. As such, for the most part, the disclosures are not an interrelated set of tables but rather discrete tables capturing assorted information that the SEC believes will be useful to investors.

The rules – and all the disclosures – are effective for Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006 and for registration and proxy or information statements filed on or after December 15, 2006 that are required to include stock compensation disclosures for fiscal years ending on or after December 15, 2006. This means that calendar year-end filers will be required to make the new disclosures in their annual reports for 2006. The new rules also apply to small business issuers, but require less extensive disclosure. The disclosure requirements for foreign private issuers are not affected by the new rules.

Named Executive Officers

The number of named executive officers in the Summary Compensation Table remains at five. However, the principal executive officer (PEO, formerly the CEO) and the principal financial officer (PFO) are named executive officers regardless of compensation level. The other three named executives are the most

highly compensated executive officers identified on the basis of *total* compensation, not simply salary and bonus. Total compensation for this purpose includes all compensation listed in the Summary Compensation Table except for non-qualified deferred compensation earnings and the accumulated net change in pension value.

Compensation Discussion & Analysis

In the new CD&A, registrants must analyze and discuss the material factors underlying compensation policies and decisions reflected in the data presented in the tables in the same manner that they discuss operations and financial condition in MD&A. The Commission provided the following key questions that registrants are required to address:

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How does each element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements?

In response to these questions, registrants should address the following types of issues that the Commission provided as examples:

- Policies for allocating between deferred and current compensation;
- Policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation (e.g., options, stock appreciation rights, restricted stock, etc.);
- The specific items of corporate or individual performance taken into account in setting compensation policies and making compensation decisions (e.g., metrics such as revenue, net income, return on equity, return on assets, etc.);
- How specific elements of compensation are structured and implemented to reflect these performance criteria and, to the extent awards could be granted without meeting the performance measurements, the circumstances in which such discretion has been exercised;
- The factors considered in decisions to materially increase or decrease compensation;
- How compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., gains from prior option or stock awards when setting retirement benefits);
- The effect of accounting and tax treatments of a particular form of compensation;
- The company's equity or other security ownership requirements or guidelines (e.g., requirement to own a defined amount of company stock) and any company policies regarding hedging the economic risk of such ownership;
- Whether the company engaged in any benchmarking of total

compensation or any material element of compensation and if so, the identity of the benchmark and the companies included in the benchmark group;

- The role of executive officers in the compensation process; and
- How the determination is made as to when awards are granted, including awards of equity-based compensation such as options.

The Commission developed the last example in response to the widely-reported stock option dating problems. Registrants may have a policy of selecting option grant dates in coordination with the release of material non-public information. For example, a company may grant options when it is aware of material non-public information that is likely to result in an increase in the stock price (e.g., positive earnings release or product development announcement). Conversely, a company may delay the granting of options until after the release of material non-public information that is likely to result in a reduction in stock price. In such cases, companies should:

- Disclose the policy and how it fits with the company's compensation program as a whole;
- Define the role of the compensation committee in approving and administering these options; and
- Identify the role of the executive officers in this option program.

Like MD&A, the CD&A requirements are straightforward but challenging to implement. The Commission structured the CD&A to support compliance with the rules by requiring companies to "file" rather than "furnish" the information and including the information in materials cov-

ered by the CEO and CFO certifications.

Compensation Committee Report

The amended rules change the Compensation Committee Report to make it similar to the existing Audit Committee Report. Among other things, the Compensation Committee Report should include:

- A statement that the committee reviewed and discussed the CD&A with management and that based on the review and discussions, it has recommended to the board of directors that the CD&A be included in the company's annual report on Form 10-K and, if applicable, the company's proxy or information statement.
- The names of the compensation committee members.

This report is furnished rather than filed. The Commission stated in the adopting release that the PEO and the PFO will be able to look to the Compensation Committee Report in providing certifications.

Annual Compensation

Summary Compensation Table

Registrants must report three years of compensation information in the Summary Compensation Table. However, the new rules will be implemented prospectively (i.e., companies will not be required to restate or provide any compensation information for previous fiscal years under either the old or new rules). As such, calendar year companies will be required to report only one year of data in 2006 Annual

Reports building up to three years in 2008 filings.

The Summary Compensation Table requires the following information in the column noted:

- Total Compensation – A total column showing total compensation.
- Salary and Bonus – The amount of salary and bonus earned regardless of when actually paid.
- Stock Awards – The dollar amount of stock awards granted (e.g., restricted stock, phantom stock, etc.) based on the grant date fair value of the award determined in accordance with FASB Statement No. 123 (Revised 2004), Share-Based Payment.

Registrants must disclose the *entire* fair value of the stock awards granted, rather than the amount earned/expensed under FAS 123R for service for the fiscal year.

- Option Awards – The dollar amount of option awards granted (e.g., options, stock appreciation rights) based on the grant date fair value of the award determined in accordance with FAS 123R. Registrants also must disclose incremental fair value for any option modification (e.g., repricing).

Registrants must disclose the *entire* fair value of the option awards granted, rather than the amount earned/expensed under FAS 123R for service for the fiscal year.

- Non-equity Incentive Plan Compensation – The amount earned during the fiscal year from non-equity incentive plans (i.e., awards not subject to FAS 123R). Here, registrants report incentive compensation granted on a basis *other than* the price of the com-

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pany's equity securities that is *not* settled by issuance of the company's equity securities.

- Change in Pension Value and Nonqualified Deferred Compensation Earnings – The increase in actuarial value for defined benefit and actuarial plans (including supplemental plans) during the year. This column also includes above-market earnings on non-qualified deferred compensation. Although combined in a single amount in the Table, registrants must disclose these two amounts separately in a footnote.
- All Other Compensation – The amount of any other compensation including, but not limited to, the following:
 - a. Amounts paid or accrued in connection with a termination plan or change in control;
 - b. Annual company contributions to defined contribution plans;
 - c. The dollar value of any premiums paid by the company for life insurance that is for the benefit of a named executive officer;
 - d. Gross-ups or other amounts reimbursed during the year for payment of taxes;
 - e. The compensation cost derived under FAS 123R for any securities purchased at a discount to the market price unless generally available to all shareholders or salaried personnel; and
 - f. Perquisites and other personal benefits over specified thresholds described below.

For purposes of this rule, the Commission chose not to define perquisites (herein referred to as perks). It did however describe a two step

analysis that should be used by companies when analyzing and identifying perks. First, an item is *not* a perk if it is integrally and directly related to the performance of the executive's duties; a concept that the SEC cautioned should be interpreted narrowly. For example, a laptop computer could be such an item as it is integral to the performance of an executive's duties at and away from the office.

Second, an item that is *not* a perk under the first test, is a perk if it confers a direct or indirect benefit that has a personal aspect, unless it is generally available on a nondiscriminatory basis to all employees. For example, a helicopter commute to the office could be such an item. It is not integrally related to an executive's duties, confers a benefit in terms of personal convenience, and is only available to top executives.

In all cases, once perks have been identified they should be valued based on the incremental cost to the company – not the market value of the perk. Once an aggregate \$10,000 threshold is exceeded, the perks should be identified. If any individual perk is valued at the greater of \$25,000 or 10% of the aggregate perks for a named executive officer, its value must be disclosed.

Grants of Plan-Based Awards Table

Registrants must provide the following supplemental information in the Grants of Plan-Based Awards Table for *each* grant during the most recent fiscal year:

- The number of shares of stock or units underlying the awards;

- The exercise or base price of the option awards; and
- The estimated future payouts of equity and non-equity plan awards (disclosed separately), including threshold, target, and maximum levels, if applicable.

The new table also addresses option pricing and timing. Specifically, if the grant date (as defined by FAS 123R) is different from the date on which the compensation committee took action, the date of the action must be presented in a separate column. Similarly, if the exercise price of an option grant is lower than the company's closing market price at the date of grant, the closing market price at the date of grant must be presented in a separate column. In such cases, if a price difference existed at the date of grant, the company must describe its methodology for determining the exercise price.

Narrative Disclosures

Narrative disclosures are required to accompany and explain the quantitative information included in the Summary Compensation Table and the Grants of Plan-Based Awards Table. The Commission offers the following examples of disclosures that enhance the user's ability to understand the tables:

- A description of the terms in the named executive officers' employment agreements;
- An explanation as to why any outstanding option or equity-based award was modified. The reason for changes in price, exercise period, vesting conditions, and performance criteria should be discussed; and

- The material terms of awards reported, including a description of the formula or criteria to be applied in determining the amounts payable and the vesting schedule. For example, registrants should state if dividends will be paid on the stock awards, and if applicable, the dividend rate, and whether that rate is preferential.

The Commission excluded the narrative disclosures that it proposed in the so-called “Couric clause” from the final rules. This clause would have required disclosures for up to three non-executive employees whose total compensation is greater than any of the five named executive officers. Instead, the Commission is re-proposing modified disclosures. Compensation disclosures would now be restricted to employees of large accelerated filers who have significant policy-making responsibilities and are located at a principal operating unit or a significant subsidiary. The modified disclosure would exclude employees such as actors, athletes, and traders.

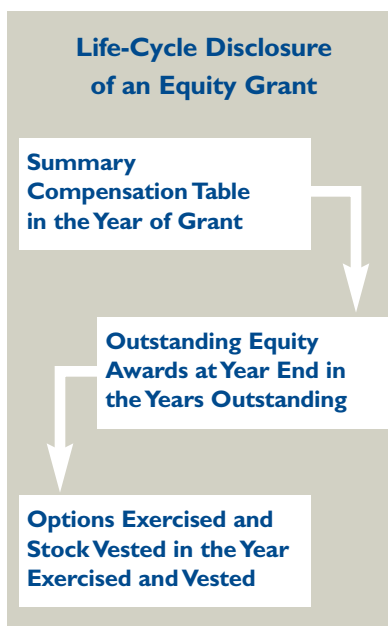
Equity Holdings

Registrants must now provide information on grants that were previously awarded in the following new tables:

- Outstanding Equity Awards at Fiscal Year-End – Includes information on equity awards previously granted that remain outstanding, unexercised, unvested, or unearned at fiscal year end.
- Option Exercises and Stock Vested – Discloses the number of shares acquired as well as the amount realized when a named executive exercises options or has

stock vest during the most recent fiscal year.

These tables complete the registrant’s disclosures over the life-cycle of equity awards granted to named executive officers as shown in the diagram that follows.



Post-Employment Compensation

The post-employment compensation tables and narrative provide aggregate information by executive for pension plans, nonqualified deferred compensation plans, and amounts potentially due upon termination of employment or change in control. The new rules require the following tables on post-employment compensation and disclosure of potential post-employment payment arrangements for the named executive officers:

- Pension Benefits Table – Includes the actuarial present value of accumulated benefit, the number of years of credited service, and any payments/benefits made to each named executive officer during the last fiscal year.

The information should be prepared using the pension plan measurement date that is defined in FASB Statement No. 87, *Employers’ Accounting for Pensions*, and used for the company’s financial statement reports. Additionally, in most cases – with the exception of normal retirement age and salary projections – the amounts would be determined using the FAS 87 group actuarial assumptions.

Each plan should be individually reported on a separate line. This table should be accompanied by narrative disclosure.

- Nonqualified Deferred Compensation Table – Includes aggregate disclosure of contributions, earnings, withdrawals/distributions and year end balances related to defined contribution or other deferred plan that is not tax qualified.

Registrants must also disclose written or unwritten arrangements that provide for potential post-employment payments. Such arrangements would include payments in connection with the resignation, severance, retirement or other termination of a named executive officer; upon a change in the named executive officer’s responsibilities; or upon a change in company control. For any event that triggers such payments, the registrant should provide amounts, assuming that the triggering event took place on the last business day of the fiscal year and that the price per share of the registrant’s securities is the closing market price as of that date.

Director Compensation

The new rules require a Director Compensation Table substantially

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similar to the Summary Compensation Table for executives. However registrants are required to present compensation information for only the most recent fiscal year.

The rules require footnote disclosure of the aggregate number of stock awards and options outstanding at fiscal year end for each director. Registrants are also required to provide narrative disclosure to explain the information presented in the table. For example, registrants should include a description of any standard compensation arrangement and to the extent an individual director has a different arrangement, identify the director and the differences.

Small Business Issuers

The disclosure requirements for small business issuers are less extensive than for regular registrants and include:

- The Summary Compensation Table and accompanying narrative disclosure;
- The Outstanding Awards at Fiscal Year-End Table; and
- The Director Compensation Table.

Small business issuers must provide the Summary Compensation Table information for the CEO and the two other most highly compensated officers for only the two most recent fiscal years. Small business issuers are not required to provide a CD&A or the related Compensation Committee Report.

Small business issuers must provide narrative disclosure addressing

defined benefit plans, defined contribution plans, and other post-employment arrangements for named executive officers. However, small business issuers are not required to provide pension plan information for these executives in the Summary Compensation Table.

Next Steps

As described above, the disclosures are extensive. Companies may require considerable time to gather the information. In light of these disclosures and the heightened focus on executive compensation, companies may want to reassess their compensation policies/procedures. As such, we urge companies to prepare for the new disclosures now and consider the following:

- Establish deadlines and assign responsibilities for the accumulation of information, the draft CD&A, and the draft tables;
- Draft a preliminary CD&A;
- Accumulate the information necessary to prepare the tables. Certain information, including the pension plan information, may require significant lead time;
- Prepare drafts of the newly required tables;
- Schedule meetings to discuss drafts with the Compensation Committee and to allow the committee adequate time for decision making.

The SEC release, *Executive Compensation and Related Person Disclosure*, is available on the SEC's website (<http://www.sec.gov/rules/final/2006/33-8732a.pdf>).

For Further Information

If you would like further information or to discuss the implications of these matters, please contact the BDO Seidman, LLP partner serving you or one of the following partners:

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