

Public Company *Insights*

Executive compensation

**Watch out for
performance pay tax traps**

Federal court strikes down SEC rule
What it means for the future of proxy access

**4 approaches to
enhanced auditors' reports**

**Rounding up recent
accounting developments**



Year End 2011

Watch out for performance pay tax traps

Year end is a good time for public companies to review their compensation programs. It's particularly important to evaluate performance-based compensation arrangements with top executives to ensure that these arrangements meet tax deductibility requirements. Failure to meet these disqualifies performance-based compensation and potentially adds hundreds of thousands — or even millions — of dollars to a company's tax bill.

Avoiding the \$1 million cap

Internal Revenue Code (IRC) Section 162 allows businesses to deduct their "ordinary and necessary expenses," including a "reasonable allowance" for salaries and other compensation. Sec. 162(m), however, limits the deduction to \$1 million per year for compensation paid to any "covered employee" of a public company. Under IRS rules, this group includes the CEO and the three highest-paid officers (other than the CEO and CFO). The compensation of these officers must be reported to shareholders under SEC rules.

At the time performance goals are established, the outcome must be substantially uncertain.

There are several exceptions to the \$1 million cap. These include payments to or from tax-qualified plans; certain benefits (such as health care and fringe benefits) that are excluded from gross



income; deferred compensation; and, perhaps most important, qualified performance-based compensation.

Meeting the requirements

For many executives, performance-based compensation eclipses their base salaries, so the deductibility of such compensation has significant tax implications. To avoid the \$1 million cap, performance-based compensation must meet several strict requirements:

Performance goals are pre-established. A company's compensation committee must establish performance goals in writing within 90 days after the performance period begins — or, if sooner, before 25% of the performance period has elapsed. For example, if compensation is based on performance during the 2012 calendar year, written goals must be established by March 30, 2012. On the other hand, if the performance period is the first six months of 2012, goals must be established by Feb. 14.

Attainment of goals is substantially uncertain. At the time performance goals are established, the outcome must be substantially uncertain. So, if an executive's bonus will depend on the company achieving an annual sales increase of at least 5%, the outcome can be called substantially uncertain.

However, if the bonus is based on a percentage of the company's total sales, the outcome is *not* substantially uncertain because the company is virtually certain to have some sales for the year. A bonus based on a percentage of the company's profits, however, would qualify because future profitability is substantially uncertain.

Compensation is nondiscretionary.

Performance-based compensation must be based on an objective standard or formula, so that "a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee." There can be no discretion to increase the amount of compensation — although discretionary *reductions* are permitted.

Some companies award executives a percentage of salary or base pay if they achieve their performance goals. This can cause the award to be discretionary because the company can increase the amount of an award by increasing the recipient's salary. But an award won't be considered discretionary if, at the time the performance goal is established, an executive's salary or base pay is fixed or a ceiling is established for total compensation.

For companies that use bonus pools, awards are considered nondiscretionary so long as the arrangement specifies each executive's share of the pool and reducing one executive's bonus doesn't increase the amounts paid to others. Stock-based compensation also may qualify as performance pay, and the IRS recently issued proposed regulations that clarify the requirements. (See "Special rules for stock-based awards" at right.)

Special rules for stock-based awards

Stock-based awards, such as stock options and stock appreciation rights (SARs), qualify as performance pay provided that:

- ▶ Compensation is based solely on the increase in stock value after the grant date, and
- ▶ The plan states the maximum number of shares for which options or SARs may be granted.

Recently proposed regulations clarify that, to qualify for the performance-based exception to the IRS's \$1 million cap (see main article), the plan must specify the maximum number of shares with respect to which options or rights may be granted to each individual employee and disclose this maximum to shareholders. Currently, many companies set only an aggregate limit.

Regulations now in effect contain a special transition rule for private companies that go public. According to the rule, compensation under a pre-IPO plan is exempt from the \$1 million cap — even if it's paid after the IPO — provided the plan is disclosed in the prospectus and certain other requirements are met. The exemption applies to stock options and SARs that are exercised, and restricted stock that vests, after the company goes public. Under the proposed new regulations, however, the exemption wouldn't apply to restricted stock units and phantom stock.

Compensation is payable on achievement of performance goals. Generally, compensation isn't considered performance-based if it's possible for an executive to receive it without achieving performance goals. An arrangement won't be disqualified, however, if compensation is payable on account of death, disability, or a change in ownership or control of the company.

At one time, qualified performance-based plans were allowed to pay compensation on account of an employee's voluntary retirement or termination without cause or for "good reason." But in 2008 the IRS ruled that these provisions would disqualify compensation arrangements for performance periods beginning on or before Jan. 1, 2009, or pursuant to employment agreements in effect on Feb. 21, 2008.

Compensation is administered by outside directors. Performance goals must be established by a compensation committee comprising solely two or more “outside” directors. Outside directors can’t be:

- ▶ Current officers or employees,
- ▶ Former employees receiving compensation for past services (other than qualified retirement plan benefits),
- ▶ Former officers, including interim CEOs (regardless of whether they’re receiving compensation for past services), or
- ▶ Receiving compensation in any capacity other than as a director.

In addition, the compensation committee must certify in writing (through approved committee minutes, for example) that performance goals have been achieved.

Shareholders approve material terms. For a plan to qualify as performance-based compensation, the company must disclose its material terms to shareholders, and secure shareholder approval, *before* compensation is paid.

Material terms include employees eligible to receive compensation (which may be a general description by title or class), a description of the business criteria on which the performance goal is based, and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation.

The description of business criteria need not disclose specific targets. For example, if a performance goal is to increase the company’s earnings per share by 10%, it’s sufficient to say that the goal is based on an earnings-per-share criterion without including the 10% measure.

Getting ready for 2012

Failure to meet just one of the above conditions can cause a company to lose valuable deductions. If your compensation program includes performance pay, review your arrangements now to ensure that compensation will be fully deductible on your 2012 tax return. Depending on your circumstances, you may need to adjust the terms of your compensation arrangements or reconstitute your compensation committee. ■

Federal court strikes down SEC rule

What it means for the future of proxy access

In July, a federal court struck down on procedural grounds the SEC’s controversial proxy access rule. While the litigation was pending, the SEC stayed the rule, which would have permitted shareholders to submit proposals to amend a corporation’s bylaws to establish proxy access procedures for shareholder nominees.

It’s uncertain whether the SEC will try to re-adopt Rule 14a-11 or adopt a new proxy access rule, but

your company needs to be prepared for any eventuality.

History of controversy

Last year’s Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) gave the SEC authority to adopt proxy access rules. Even before Dodd-Frank, proxy access had been an SEC priority and it had issued proposed rules in 2009.



But the proposal was controversial and raised a number of issues, including whether the SEC had the statutory authority to adopt them. Dodd-Frank removed any doubt about that authority, and the SEC issued its final rule, 14a-11, about six weeks after Dodd-Frank was enacted.

Court steps in

The rule required corporations to include in their proxy materials board candidates nominated by shareholders or shareholder groups who continuously owned at least 3% of the corporation's voting power for at least three years. At the same time, the SEC amended Rule 14a-8 (its shareholder proposal rule) to require companies to accept proposals for establishing proxy access procedures. Essentially, the amendment allowed shareholders to propose procedures that were less restrictive than those mandated by Rule 14a-11 — for example, those with a lower ownership threshold.

Rule 14a-11 would have taken effect Nov. 15, 2010, with a three-year deferral for smaller companies. And it would have applied to proxy materials mailed on or after March 13, 2011. But in September 2010, the Business Roundtable and the U.S. Chamber of Commerce challenged the rule in the

U.S. Court of Appeals for the D.C. Circuit. The SEC stayed Rule 14a-11, pending the outcome of the case. And although it wasn't challenged in court, the SEC also stayed its amendment to Rule 14a-8.

The appellate court vacated Rule 14a-11. It ruled that the SEC violated the Administrative Procedure Act and other laws by failing to adequately assess the rule's economic impact.

What's next?

The SEC may attempt to re-adopt Rule 14a-11 or adopt a new proxy access rule. If it does, however, it will have to start the rulemaking process from scratch. This could take some time, so it's unlikely that a rule will be established in time for the 2012 proxy season.

But it's also possible that the SEC will lift its stay on the amendment to Rule 14a-8. If that happens, it will be relatively easy for shareholders to introduce proposals to amend a corporation's bylaws to add proxy access procedures. Under Rule 14a-8, any shareholder who has owned at least \$2,000 in stock (or, if less, 1% of the company's stock) for at least one year is eligible to submit a proposal.

It's uncertain whether the SEC will try to re-adopt Rule 14a-11 or adopt a new proxy access rule, but your company needs to be prepared for any eventuality.

Engage in a dialog

If the SEC lifts its stay, your company needs to be prepared for shareholder proposals on proxy access. It's a good idea to engage in a dialog with interested shareholders as early as possible to ensure that proposals are fair to both your company and its investors. ■

4 approaches to enhanced auditors' reports

The Public Company Accounting Oversight Board (PCAOB) recently issued a concept release seeking feedback on potential enhancements to auditors' reports on public companies' financial statements. The Board undertook this project in response to investor demand for audit reports that provide greater transparency and relevance to investors and other financial statement users.

Proposed enhancements

Four potential approaches for achieving this goal are outlined in the release:

1. New auditor discussion and analysis. This supplemental narrative report would provide users with "a view of the audit and the financial statements 'through the auditor's eyes.'" It would discuss the auditor's views on matters such as:

- ▶ Significant risks identified in the audit,
- ▶ Audit procedures performed in response to such risks,
- ▶ Management's judgments, critical accounting estimates and related assumptions,
- ▶ Quality of the company's accounting policies and practices, and
- ▶ Auditor independence.

In addition, the report would discuss difficult or contentious audit issues, including "close calls."

2. Expanded use of emphasis paragraphs. Currently, auditors are allowed to add emphasis paragraphs to their reports to draw attention to certain financial statement issues. These include the company's status as a component of a larger enterprise, significant related-party transactions and unusually important subsequent events.



The new approach would require emphasis paragraphs in all audit reports and expand them to highlight the most significant financial statement matters, such as management judgments and estimates or areas with measurement uncertainty. Auditors might also be asked to identify key audit procedures related to these matters.

3. Reporting on information outside the financial statements. Auditors would be required to provide assurance on information outside the financial statement, such as Management's Discussion and Analysis (MD&A) in the company's annual report. Auditors would also cover earnings releases and non-GAAP information.

4. Explanation of terms and concepts. The auditor would provide additional explanation of key terms and concepts in the report, such as reasonable assurance and management's responsibility for the preparation of financial statements. The auditor also would provide clarification on his or her independence and responsibility for fraud, financial statement disclosure and information outside the financial statements.

Potential impact

In its release, the PCAOB emphasizes that the four alternatives presented aren't mutually exclusive. If the board ultimately proposes revised standards for auditors' reports, those standards might be based on one of the alternatives, some combination of two or more alternatives, or elements thereof. It's also possible the board will propose other alternatives not considered in the release.

The PCAOB doesn't intend to fundamentally change the auditor's role. In general, its suggested approaches focus on improving and expanding the

contents of the auditor's report to enhance communication with investors and other financial statement users. Nevertheless, expanded reporting may demand audit procedures beyond those currently required and, therefore, new auditing standards.

The next step

Keep in mind that a concept release isn't a formal proposal to adopt new standards, but a way of testing the waters. Public comments on the concept release will guide the PCAOB in determining whether to proceed to the proposal stage and, if so, how and when to do it. ■

Rounding up recent accounting developments

Keeping up with changing accounting standards is critical to every public company's well-being. Consider these latest developments.

IFRS "condorsement"?

The SEC continues to discuss whether — and when — to adopt International Financial Reporting Standards (IFRS) for U.S. companies. Earlier this year, the commission published a staff paper floating the idea of "condorsement," a combination of convergence and endorsement.

Rather than switch to IFRS, U.S. companies would continue to follow U.S. Generally Accepted Accounting Principles (GAAP). During a transition period, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) would continue their project to converge major standards under U.S. GAAP and IFRS. At the same time, FASB would develop a process for considering new IFRS standards for incorporation into U.S. GAAP. Ideally, these standards would be incorporated as is, although a protocol would be established for considering U.S.-specific modifications.

Revenue recognition and lease accounting re-exposed

FASB and IASB are "re-exposing" their proposals for joint standards on revenue recognition and lease accounting. The two boards published their proposed overhaul of the two standards in 2010, but made significant revisions to the original exposure drafts to address the many comments they received.

The boards are re-exposing their proposals to give interested parties an opportunity to comment on the revisions. Final standards are expected in mid-2012.

Simplifying goodwill impairment testing

FASB recently approved its proposal to simplify goodwill impairment testing. Currently, companies that report goodwill must perform costly tests at least once a year.

Under the amended rules, companies first analyze qualitative factors — such as economic or industry conditions — to determine the likelihood that goodwill is impaired. Companies must perform valuations only if it's more likely than not that a reporting unit's fair value is less than its carrying amount. The amendments apply to annual and interim goodwill impairment tests starting in fiscal years beginning after Dec. 15, 2011, but early adoption is permitted.

