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Heads Up

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Payback Time
SEC Proposes Rule on "Clawback" Policies

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The SEC recently issued a proposed rule[1] aimed at ensuring that executives do not receive "excess compensation" if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements. Specifically, the proposal would implement the mandate in Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") that requires the SEC to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that has not adopted a written policy providing for the recovery of incentive-based compensation (IBC) under certain circumstances. It would also amend paragraph (b) of Regulation S-K, Item 601,[2] to require that a listed issuer disclose its recovery policy in an exhibit to its annual report.

The proposed rule raises numerous questions and poses potential challenges. To obtain feedback from stakeholders, the SEC is requesting comments on 101 questions related to the proposal. Comments are due by September 14, 2015.

This *Heads Up* discusses key provisions of the proposed rule and their potential accounting and tax consequences to help companies better understand the proposal and determine how (or whether) to comment on it.

The Proposal's Provisions

Scope of Recovery Policies

Under the proposed rule, issuers would be required to adopt a written policy requiring them to recover "excess" IBC awarded to any individuals (including former employees) that served as an executive officer during the three most recently completed fiscal years preceding the date on which it is determined that a qualifying financial restatement is required, provided that the executive officers were awarded more IBC than they would have received if the financial statements had been prepared correctly. Unlike many of the recovery policies adopted by companies to date, policies under the proposed rule would require recovery of executives' excess IBC even if the executives were not involved in the preparation of the financial statements or did not commit misconduct that led to the restatement. That is, the proposed rule would require companies to adopt a "no-fault" policy under which individuals would have to repay

[1] SEC Proposed Rule Release No. 33-9861, *Listing Standards for Recovery of Erroneously Awarded Compensation*.
[2] SEC Regulation S-K, Item 601, "Exhibits."

any excess IBC awarded to them regardless of whether they contributed to the restatement. Even restatements attributable to an inadvertent error would potentially subject executive officers to the recoupment of previously earned IBC.

Key provisions of the proposed rule are described below.

Issuers Subject to the Rule

The proposed rule would require exchanges to apply the disclosure and recovery requirements to all listed issuers not falling within very limited exceptions. Emerging growth companies, smaller reporting companies, and controlled companies would all be subject to the proposal since the SEC believes that the objective of recovering excess compensation is as relevant for these types of companies as it is for any other listed issuer. While some exchanges currently allow foreign private issuers to follow home country rules in lieu of certain U.S. corporate governance requirements, the proposed rule would not permit the exchanges to exempt foreign private issuers from compliance with the proposed disclosure and recovery requirements.

The listing standards would apply to issuers regardless of the types of securities they have issued, including issuers of listed debt or preferred securities that do not have listed equity.[3]

Restatements Triggering Application of the Recovery Policy

The Dodd-Frank Act requires recovery of excess compensation paid to executives "in the event that the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws." The SEC has concluded that an error that is material to previously issued financial statements represents "material noncompliance" by the company. Therefore, the SEC is proposing that issuers be required to adopt and comply with a written policy providing that if the company is required to issue a "restatement"[4] to correct an "error" that is "material to previously issued financial statements," the obligation to prepare the restatement would trigger application of the recovery policy.

The SEC's proposal defines an accounting restatement as "the result of the process of revising previously issued financial statements to reflect the correction of one or more errors that are material to those financial statements." The proposed rule does not specify what characteristics or types of errors would make errors material because the SEC believes that materiality should be determined within the context of each company's facts and circumstances.

However, the SEC has identified types of changes to a company's financial statements that **do not** represent error corrections and therefore would not trigger application of a company's recovery policy under the proposal. Such changes include (1) "[r]etrospective application of a change in accounting principle" and (2) "[r]etrospective reclassification due to a discontinued operation."[5]

[3] The proposal does, however, provide an exemption for listings of (1) security futures products, (2) standardized options, and (3) securities issued by certain registered investment companies, such as unit investment trusts.

[4] As defined under U.S. GAAP or IFRSs, as appropriate. ASC 250-10-20 defines a restatement as the "process of revising previously issued financial statements to reflect the correction of an error in those financial statements." In addition, ASC 250-10-20 defines the term "error in previously issued financial statements." (For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*.") For the definition of a "retrospective restatement" and "prior period errors" under IFRSs, see paragraph 5 of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. Refer to the Accounting Considerations section below for additional discussion.

[5] As stated in the proposal, the following changes to financial statements are also not considered error corrections that would require a company to apply its recovery policy:
- "Retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization."
- "Retrospective application of a change in reporting entity, such as from a reorganization of entities under common control."
- "Retrospective adjustment to provisional amounts in connection with a prior business combination."
- "Retrospective revision for stock splits."

Date on Which the Issuer is Required to Prepare an Accounting Restatement

Under the proposed rule, the date on which an issuer is required to prepare a restatement is **the earlier of**:

- "The date the [issuer] concludes, or reasonably should have concluded, that the issuer's previously issued financial statements contain a material error."
- "The date a court, regulator or other legally authorized body directs the issuer to restate its previously issued financial statements to correct a material error."

Under this approach, it is possible that the triggering event will occur before the exact amount of the error has been finalized. Importantly, a company's obligation to recover excess compensation does not depend on when (or whether) the company files with the SEC (1) a Form 8-K containing disclosures under Item 4.02 or (2) restated financial statements.

Executive Officers Subject to the Recovery Policy

The Dodd-Frank Act states that excess IBC must be recovered from "any current or former executive officer of the issuer who received incentive-based compensation." However, the Dodd-Frank Act does not define "executive officer" for purposes of the recovery policy.

Under the proposal, the definition of "executive officer" selected by the SEC is modeled on the SEC's definition of "officer" in Rule 16a-1(f) of the Securities Exchange Act of 1934. Individuals who qualify as executive officers under the proposed definition include:

- The issuer's president.
- The issuer's principal financial officer.
- The issuer's principal accounting officer.
- Any vice president of the issuer who is in charge of a principal business unit, division, or function.
- Any other officer of the issuer who performs a policy-making function.
- Any other person who performs similar policy-making functions for the issuer.[6]

The SEC concluded that the Dodd-Frank Act requires recovery of excess IBC provided for service as an executive officer. Therefore, the proposed rule requires recovery of excess IBC received by an individual who served as an executive officer of an issuer at any time during the performance period for that IBC. Recoverable amounts could include awards granted before the individual began serving as an executive officer as well as new-hire grants, as long as the individual served as an executive officer during any portion of the award's performance period. As proposed, if the executive officer was not an executive officer at any time during the award's performance period, the recovery policy would not apply.

Editor's Note: Because the proposed rule would apply to current and former executive officers, companies should consider keeping an updated list of the individuals who served as executive officers during the prior three years. It would also be advisable to maintain current contact information regarding any former employees who served as executive officers.

[6] Executive officers of the issuer's parent or subsidiaries would be deemed executive officers if they perform policy-making functions for the issuer.

Definition of IBC

The proposal defines IBC as "any compensation that is **granted, earned or vested** based wholly or in part upon the attainment of any financial reporting measure" (emphasis added). Such compensation includes both cash-based and equity-based incentives.

Financial reporting measures are defined as (1) "measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements," (2) "any measures derived wholly or in part from such financial information," and (3) "stock price and total shareholder return" (TSR). Performance measures would be covered by this definition regardless of whether they are included in an SEC filing or are presented outside of the financial statements (e.g., in MD&A). Financial reporting measures under the proposal include, but are not limited to:

- Revenues.
- Net income, operating income, and other earnings measures (e.g., EBITDA or earnings per share), including non-GAAP measures that have been adjusted to exclude specified items.
- Liquidity measures.
- Return measures.
- Financial ratios.

When stock price and TSR are the financial reporting measures used to determine an incentive payout, issuers would be permitted to use "reasonable estimates" to determine the impact that their revised financial results would have had on those measures at the time performance was measured. Issuers would also be required to disclose those estimates.

The proposal's definition of IBC does not include all types of incentive compensation. Any incentive awards that are granted, earned, or vested solely on the basis of whether nonfinancial measures have been achieved (e.g., awards related to achieving safety goals, obtaining regulatory approvals, or opening a targeted number of new stores or franchises) would not be subject to the recovery policy as proposed.

Importantly, stock options and other equity awards would be treated as IBC only if the grant or vesting of the award is based (in whole or in part) on the attainment of any financial reporting measures. Therefore, stock options, stock appreciation rights (SARs), restricted stock, and restricted stock unit (RSU) awards that vest solely on the basis of continued service would **not** be considered IBC.[7]

The following examples are types of compensation that would be subject to the recovery policy if they are granted, earned, or vested on the basis of whether a financial reporting measure was attained:

- Cash-based incentive awards.
- Bonuses paid from a "bonus pool" (if the size of the pool is determined on the basis of whether a specified financial reporting measure was achieved).
- Restricted stock, RSUs, performance share units, stock options, and SARs.
- Proceeds received upon the sale of shares acquired through an incentive plan.

[7] In addition, base salaries, retention bonuses, and cash incentives based on the attainment of nonfinancial strategic or operational measures would not be considered IBC.

Editor's Note: Companies that use stock price or TSR as a basis for compensation awards must be able to reasonably estimate the effect of a restatement on stock price (at the time the incentive payments were determined) to determine the amount of the excess IBC paid to executive officers. Estimating what the stock price would have been at the end of the performance period had the financial results been reported correctly could prove challenging in practice. Given the lack of correlation between earnings or other financial measures and stock price at some companies, it is unclear how a reasonable estimate of the stock price that reflects the error corrections should be determined.

In addition, since IBC as defined under the proposed rule would exclude equity awards that are granted or vested solely on the basis of continued service, the proposal may create a potential bias toward companies' granting time-vesting awards. However, we do not expect a significant shift in long-term incentive granting practices given the likelihood that companies will remain focused on demonstrating the strong link between pay and performance in their executive compensation programs through the use of performance shares.

Time Period Covered by the Recovery Policy

Under the proposed rule, the three-year look-back period for the recovery policy would consist of the "three completed fiscal years immediately preceding the date the issuer is required to prepare an accounting restatement."

The proposal to base the look-back period on fiscal years rather than the 36-month period before the restatement is intended to align the recovery policy with compensation-related decisions, which the SEC noted are generally made by companies on a fiscal-year basis. For example, if a calendar-year company determines in July 2019 that a restatement of financial statements is required because of material noncompliance with financial reporting requirements, the recovery policy would apply to IBC that was "received" in 2016, 2017, and 2018.

For companies that changed their fiscal year during the three-year look-back period, the look-back period would be extended to include the transition period.

When IBC Is "Received"

As proposed, IBC would be considered received in the fiscal period during which the associated financial reporting measure is attained even if the executive officer does not actually receive payment or grant of the award until after the end of that period. For example, if an equity award vests upon attainment of a financial reporting measure, the award would be deemed received in the fiscal period when it vests. A cash incentive earned upon attainment of a financial reporting measure is deemed received in the period in which the goal is attained.

The date on which the award is received may be different from the date on which the award vests (e.g., there could be additional service-based vesting required after the financial reporting measure is attained). In addition, any "ministerial" actions or other conditions required to effect issuance or payment (e.g., obtaining compensation committee approval for payment) would not affect the determination of the date on which compensation is "received."

Importantly, IBC received by an executive officer before the company's securities become listed would **not** be subject to the recovery policy.

Determination of Excess Compensation

As proposed, the recoverable amount is defined as "the amount of incentive-based compensation received by the executive officer or former executive officer that exceeds the amount of incentive-based compensation that otherwise would have been received had it been determined based on the accounting restatement."

After concluding that a previously issued financial statement contains a material error (or being directed by a legally authorized body to issue a restatement), an issuer would be required to recalculate incentive compensation payments on the basis of the restated financial reporting measure. The issuer would then need to determine whether an executive officer received a greater amount of IBC than what he or she would have received had the financial statements been prepared correctly. As discussed in Definition of IBC above, for IBC that is based on stock price or TSR, the recoverable amount may be based on a "reasonable estimate" of the effect of the restatement on stock price. The company would be required to (1) maintain documentation of its reasonable estimate and (2) provide the documentation to the relevant stock exchange.

The recoverable amount would be determined on a **pretax** basis to ensure that the company recovers the full amount of excess IBC. The application of the proposed rule to specific types of compensatory arrangements is described below.

Cash-Based Awards

An issuer that paid cash-based incentive compensation from a bonus pool would recalculate the aggregate size of the pool by using the restated financial reporting measure. If the revised bonus pool is less than the aggregate amount of bonuses paid, (1) the excess amount paid to executive officers would be equal to the same percentage reduction in the bonus pool and (2) the excess amount for each individual executive officer would be determined on a proportional basis.

Share-Based Awards

Under the proposal, excess share-based awards would be recoverable as follows:

- If shares, stock options, or SARs are held by the individual at the time of recovery, the recoverable amount would be the number of awards received in excess of the number that would have been received had there been no restatement.
- If stock options or SARs have been exercised but the underlying shares were not sold, the recoverable amount would be the number of shares underlying the excess options or SARs after the restated financial measure has been applied, reduced by any exercise price paid.
- If the shares have been sold, the recoverable amount would be the sales proceeds attributable to the excess number of shares.

Nonqualified Deferred Compensation

The executive officer's account balance or distributions would be reduced by (1) the excess IBC contributed to the nonqualified deferred compensation plan and (2) the interest or other earnings accrued on the applicable amounts.

Coordination With Section 304 of the Sarbanes-Oxley Act

To the extent that an executive officer has already reimbursed the company in accordance with the recovery required by Section 304 of the Sarbanes-Oxley Act of 2002, the amount reimbursed would offset the amount of the recovery owed if the company's compensation recovery policy requires repayment of the same compensation by that executive officer.

Editor's Note: For companies that use a combination of financial and nonfinancial metrics to determine incentive payouts, the determination of excess compensation would apply only to the portion of the award that was based on financial reporting measures. When a company uses a financial metric to fund a bonus pool, there is no excess compensation subject to recovery if the actual aggregate distributions to individual participants were less than (1) the amount that was initially funded and (2) the amount that would have been funded for the bonus pool if the financial statements had been prepared correctly.

Board Discretion in Determining Whether to Seek Recovery

The SEC recognizes that there may be circumstances in which pursuing the recovery of excess IBC may not be in the interest of shareholders. Therefore, the proposed rule provides that issuers must recover erroneously paid compensation unless (1) the direct costs of enforcing recovery (i.e., costs requiring financial payments, such as reasonable legal fees) would exceed the recoverable amount or (2) pursuing recovery would violate home country law.[8]

Before concluding that enforcement costs would make it impracticable to recover any amount of IBC, an issuer would need to make a reasonable attempt to recover the IBC. An issuer would also be required to document its attempt to recover such IBC and provide that documentation to the listing stock exchange. Similarly, before concluding that attempts to recover any amount of IBC would violate home country law, an issuer would first need to obtain an opinion from home country counsel that seeking recovery would result in a violation.

Any determination that recovery would be impracticable must be made by the issuer's compensation committee (or, in the absence of a compensation committee, a majority of the independent directors serving on the issuer's board).

Editor's Note: Many companies have already adopted compensation recovery policies that give the board of directors (or the compensation committee) broad discretion to determine (1) whether to seek recovery of excess IBC and (2) the individuals from whom to seek recovery. The proposed rule significantly reduces the board's ability to exercise such discretion.

Means of Recovery

The SEC staff recognized that the appropriate approach for recovery of excess IBC may vary by company and by type of compensation. As a result, the proposed rule would allow a company to exercise discretion in determining the best way to recover excess IBC as long as executive officers are prevented from retaining compensation to which they are not entitled.

The proposed rule would also require a company to recover excess IBC "reasonably promptly" since "undue delay" would constitute noncompliance with the required recovery policy.

Compliance With Recovery Policy

Under the proposed rule, a company would be subject to delisting if it does not adopt and comply with its compensation recovery policy. The proposed rule does not establish a time frame for completing the recovery of excess IBC. Instead, the listing stock exchange would determine whether the steps taken by the company constitute compliance with the company's recovery policy (e.g., by considering whether the company "was making a good faith effort to promptly pursue recovery").

[8] The relevant home country law must have been adopted in such home country before July 14, 2015.

Disclosure Implications

The proposed rule would amend Item 601(b) of Regulation S-K to require that a listed issuer disclose its recovery policy as an exhibit to its annual report.

In addition, the proposal would amend Regulation S-K, Item 402,[9] to require a company to disclose how it applied its recovery policy. For example, a company would be required to disclose its actions to recover erroneously awarded compensation if either of the following occurred at any time during the last completed fiscal year:

- The company completed a restatement that required it to recover excess IBC in accordance with its recovery policy.
- The company had an outstanding balance of excess IBC as a result of applying its recovery policy to a prior restatement.

In these situations, the company would be required to provide the following additional disclosure in its Item 402 disclosure:[10]

- For each restatement:
  - The date on which the company was required to prepare an accounting restatement.
  - The amount of excess IBC attributable to the restatement.
  - The amount of excess IBC outstanding at the end of the last completed fiscal year.
- The estimates used to determine the excess IBC attributable to the accounting restatement if the financial reporting measures were related to stock price or TSR.
- The name of each person subject to recovery of excess IBC from whom the company decided during the last completed fiscal year not to pursue recovery, the amount forgone for each individual, and a brief description of the reason the company decided not to pursue recovery.
- The name of, and amount due from, each individual from whom, as of the end of the last completed fiscal year, excess IBC had been outstanding for at least 180 days since the date the company determined the amount owed by the individual.

Since this disclosure requirement would apply to any current or former executive officer subject to the recovery policy (as opposed to only the named executive officers (NEOs) as defined in Regulation S-K, Item 402), the SEC proposes to treat the contemplated disclosure as a separate item rather than an additional matter for inclusion in a company's Compensation Discussion and Analysis (CD&A). However, companies could elect to include the proposed new disclosure in the CD&A if they are required to disclose the recovery of NEOs' compensation in the CD&A.

The SEC's proposal would also amend the summary compensation table disclosure requirements in Regulation S-K, Item 402(c). Under the proposal, companies would be required to (1) reduce the amount originally reported in the applicable column of the summary compensation table by the amount recovered in accordance with the company's recovery policy for the applicable fiscal year and (2) identify the amount recovered in a footnote to the summary compensation table. The amount reported as total compensation for the applicable year(s) would also be updated. The new requirement would apply in any filing that requires summary compensation table disclosure for the affected fiscal year(s).

[9] SEC Regulation S-K, Item 402, "Executive Compensation."

[10] The disclosure requirements would also apply to foreign private issuers. These issuers would file their recovery policies as an exhibit to the annual reports they file with the SEC on Form 20-F.

Indemnification and Insurance

Under the proposed rule, companies would be prohibited from indemnifying any current or former executive officer against the loss of erroneously awarded compensation. Companies would also be prohibited from paying or reimbursing executive officers for the payment of insurance premiums on a policy that covers potential recovery obligations. The SEC believes that indemnification and insurance would defeat the ultimate purpose of Section 954 of the Dodd-Frank Act — i.e., to prevent executive officers from retaining compensation that they would not have received if (1) the financial statements had been prepared correctly and (2) there had been no overpayment of compensation.

Transition and Time Frame for Implementation

Under the proposed rule, the time frame for implementing the mandatory compensation recovery policy would be as follows:

Event	Time Frame
Exchanges' filing of new listing rules	90 days after publication of the final SEC rule in the *Federal Register*
Effective date of new listing rules	No more than one year after publication of the final SEC rule in the *Federal Register*
Companies' adoption of a compliant recovery policy	No more than 60 days after the effective date of the new listing rules

In addition, the proposal would require companies to recover all excess IBC received by current and former executive officers (1) **for any fiscal period ending on or after the effective date of the new rules** and (2) that is **granted, earned, or vested** on or after the effective date of the final SEC rule.

Editor's Note: In light of the proposed accelerated time frame for adopting the mandatory compensation recovery policy and the fact that the recovery policy could apply to unearned and unvested awards of IBC granted before the effective date of the new listing rules (if earned or vested after the effective date), an affected company should:

- Monitor the timing of both the issuance of the final SEC rule and the adoption of the exchanges' new listing rules. This is because the company would have a limited amount of time (60 days as proposed) in which to amend its existing recovery policy or adopt a new policy once the listing rules have been approved.
- Establish a cross-functional team from its human resources and legal departments to:
  - Review the company's existing recovery policy and begin considering changes that may be necessary to comply with the SEC's final rule.
  - Review executive officers' employment and/or letter agreements to (1) determine whether there is any potential conflict between the terms of the agreements and the proposed SEC rule and (2) consider whether the company needs to amend those agreements.
  - Review the form of the company's stock award agreements, the terms of its annual bonus plan, and its long-term incentive plan to determine whether they permit the recovery of excess IBC and whether they should be updated.

Accounting Considerations

As companies contemplate how to respond to the SEC's request for comments on its proposal, they should consider the potential accounting consequences of the proposed rule, particularly its possible effects on the accounting for share-based payment arrangements. Under ASC 718, an equity-classified award issued to an employee is generally (1) measured on the basis of the fair value of the award on the grant date and (2) recognized over the requisite service period.

The discussion below outlines various accounting considerations related to the proposed rule and share-based payment awards.[11]

Establishing a Grant Date

One of the conditions for establishing a grant date is that the employer and its employees must "reach a mutual understanding of the key terms and conditions of a share-based payment award."[12] If the key terms of an award are overly broad, subjective, or discretionary, there may be a delay in establishing a grant date for accounting purposes, which would, in turn, delay the establishment of a measurement date for determining the fair-value-based measure of the award. In addition, if certain conditions are met such that the service inception date precedes the grant date,[13] compensation cost may need to be recognized on the basis of the fair value of the award as of each reporting date until a grant date is established even if the award is classified as equity (i.e., "mark-to-market" or "variable" accounting before the grant date).

Editor's Note: We expect that clawback policies adopted to comply with the provisions of the proposed rule will not preclude a company from establishing a grant date because the proposal will require such policies to be well-defined and sufficiently objective. Conversely, clawback policies that are subjective or that allow the exercise of discretion to determine when an IBC clawback is triggered could preclude an issuer from establishing a grant date because the clawback-triggering event would generally be a "key" term or condition for which a mutual understanding must exist. Therefore, in a company's policies, it is especially important for the contingent event that triggers the clawback to be well-defined and sufficiently objective.

As noted above, the proposed rule provides that a potential clawback of IBC would be triggered by a material accounting restatement because it is deemed to represent "material noncompliance" by the company with financial reporting requirements under the securities laws. While a company must use judgment to determine whether an accounting restatement is "material," the need for such judgment should not preclude a company and its employees from reaching a mutual understanding of the key terms and conditions of a share-based payment award. Likewise, other provisions in the proposed rule that would allow a company to exercise some level of discretion or judgment when applying its recovery policy (e.g., the provision under which a company would not have to recover erroneously awarded IBC if it deemed pursuit of such recovery to be impracticable) should not preclude the establishment of a grant date.

[11] While this discussion focuses on share-based payment awards that are classified as equity, some of the same considerations could apply to awards classified as liabilities.

[12] Refer to ASC 718-10-20 for the definition of a grant date.

[13] Refer to ASC 718-10-35-6 and the related implementation guidance in ASC 718-10-55-108.

Editor's Note: While the definition of an accounting restatement under the proposed rule is mostly consistent with the definition of a restatement in ASC 250, the proposed rule's definition differs in that it applies only if the error or errors are "material" to the financial statements. As noted above, the SEC decided not to describe the types of errors that would be considered material because "materiality is a determination that must be analyzed in the context of particular facts and circumstances. Moreover, materiality has received extensive and comprehensive judicial and regulatory attention." Issuers should consider SAB 1.M[14] and SAB 1.N[15] when determining whether a material accounting restatement is required.

Generally, a restatement for an error is handled in one of two ways. When an error is material, the company ordinarily amends the prior filing and files a Form 8-K containing disclosures under Item 4.02 (such a restatement is sometimes referred to as a "big R"). When an error is immaterial, the company includes the restatement in its next periodic filing (sometimes referred to as a "little R"). Some may wonder whether "material" as used to decide between a big R and a little R restatement would always mean the same thing as "material" for clawback purposes under the proposed rule (i.e., whether a big R restatement would always result in a clawback and a little R restatement would not). If the meaning of materiality is the same for both purposes, that will put additional importance and focus on the decision made by a company and an auditor about whether an error is material for purposes of effecting the restatement. At present, we are unaware of reasons why there would be a difference in assessing materiality for the two purposes, but there could be additional dialogue or developments on this important issue, or the issue could be clarified in the final rule.

Accounting for a Clawback

If a company concludes that a material restatement is required and that clawback of IBC is triggered, there are additional complexities associated with accounting for the clawback. Because there is currently no guidance in U.S. GAAP that directly addresses how to account for the type of compensation clawback described in the proposal, there are different views on what the appropriate accounting treatment would be. Such views are discussed below.

View 1 — Clawback Accounting

Under View 1, contingent features such as clawback provisions are not reflected in the fair-value-based measure of an equity instrument on the grant date and do not affect the recognition of compensation cost if they are triggered after the equity instrument is earned.[16] Therefore, a clawback provision has no day-one impact on the accounting for an award, and the clawback would be accounted for only if and when it is triggered by a contingent event (i.e., a material restatement).

Supporters of this view point to the guidance in ASC 718 that addresses how to account for clawbacks of awards that have been earned (i.e., vested).[17] Using that guidance, a clawback of IBC would be recognized when (1) the material restatement triggering the clawback occurs after an award has been earned and (2) the consideration is received or receivable. At that time, the company would recognize (1) the consideration returned by the individual, (2) a receivable for such consideration, or, if the individual returns shares, (3) treasury stock at the fair value of those shares. It also would recognize as other income the fair value of the consideration received to the extent that it previously recognized

[14] SEC Staff Accounting Bulletin Topic 1.M, "Materiality."

[15] SEC Staff Accounting Bulletin Topic 1.N, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements."

[16] Refer to ASC 718-10-30-24 and ASC 718-10-55-8.

[17] If the award is not vested, refer to the other views discussed below.

compensation cost for awards that were subject to the clawback; any excess of fair value of the consideration received over the previously recognized compensation cost would be recognized as an increase to additional paid-in capital.[18]

Opponents of this view believe that the clawback guidance in ASC 718 presumes that the triggering event occurred in the current period (e.g., a noncompete violation that triggers a clawback would be a current-period event) and does not involve facts under which the award would never have been received in the first place on the basis of the restated financial measures.

View 2 — Forfeiture Accounting

View 2 holds that if an award has a performance condition, accruals of compensation cost should be based on the probable outcome of that performance condition. That is, compensation cost is accrued only if it is probable that the performance condition will be achieved; otherwise, no compensation cost is accrued. Compensation cost is not recognized if awards are forfeited because a performance condition is not satisfied.[19] However, if the award has a market condition, compensation cost is recognized even if the market condition is not satisfied as long as the requisite service is rendered. This is because a market condition is not a vesting condition but is reflected in the fair-value based measure of the award on the grant date.[20]

ASC 718 addresses how to account for changes in estimates if an award has not been earned (i.e., is not vested).[21] Proponents of View 2 believe that (1) a material restatement that potentially triggers a clawback will also trigger a change in a company's estimate about whether an award will vest and (2) the change in estimate should be recognized in the period in which the restatement is triggered. Therefore, if a material restatement occurs[22] before the award has vested, the company should reassess whether the award is still probable of vesting on the basis of the restated financial measures. If the award is not probable of vesting, compensation cost should not be recognized, and any compensation cost previously recognized should be reversed. If, on the other hand, there is a material restatement related to a market condition, as noted above, compensation cost is still recognized even if the market condition is not satisfied as long as the requisite service is expected to be rendered.

Opponents of this view believe that a material restatement does not result in a current-period change in estimate of compensation cost since it is not based on "new information"[23] but is a correction of compensation cost that was recognized on the basis of erroneous information. Accordingly, like opponents of View 1 above, opponents of View 2 believe that compensation cost should also be corrected as part of the restatement because it involves facts under which the award would never have been received in the first place on the basis of corrected financial measures.

View 3 — Cancellation Accounting

Proponents of View 3 maintain that if an award is canceled without a replacement award or other valuable consideration, the cancellation is accounted for as a repurchase for no consideration. If the award is not vested, any previously unrecognized compensation cost is recognized as of the cancellation

[18] Refer to ASC 718-20-55-85.
[19] Refer to ASC 718-10-25-20 and ASC 718-10-30-12.
[20] Refer to ASC 718-10-30-14.
[21] For example, assume that an award is based on a performance condition with a three-year performance period ending in the issuer's 20X1 fiscal year but is subject to service-based vesting for two additional years. If the issuer concludes in late 20X2 that its 20X1 fiscal year is subject to a material restatement that triggers recovery for awards received in 20X1, that award would be deemed "received" under the proposed rule in 20X1 because the performance condition is "attained" (i.e., the performance condition is achieved), even if the award is subject to additional vesting (i.e., has not been earned).
[22] While a material restatement could trigger the clawback of IBC, a material restatement may not necessarily trigger the clawback, particularly if the restatement is triggered before the performance condition is attained (i.e., achieved).
[23] Refer to ASC 250-10-20 for the definition of a change in accounting estimate.

date[24] since the award is deemed to be effectively vested on an accelerated basis and then canceled (or repurchased for no consideration).

Under this view, the cancellation guidance in ASC 718 addresses how to deal with the cancellation of an award regardless of whether the award is vested. Therefore, if a material restatement triggering clawback of IBC occurs, the award is effectively canceled, and any previously unrecognized compensation cost associated with unvested awards is recognized in the current period.

Opponents of this view believe that there is no subsequent decision to cancel the award upon a material restatement since any clawback policy adopted by a company under the proposed rule would represent an existing term of the award that provides for automatic and generally nondiscretionary clawback of erroneously paid IBC.

View 4 — Lower Compensation Cost in the Restated Periods

View 4 holds that when financial statements are restated, each individual prior period presented is adjusted to reflect the correction of the period-specific effects of the error.[25]

Under this view, if there is a material restatement that triggers clawback of IBC, the impact of erroneously paid IBC is a direct effect of the error correction irrespective of whether the award has been earned. While the other views above reflect different models provided in ASC 718, they potentially affect only current-period income because of a conclusion in the current period that a material restatement triggering clawback of IBC is required. This treatment is consistent with ASC 718's illustration of a clawback feature related to the type of noncompete violation discussed in connection with View 1 above. In that illustration, a violation of a noncompete provision is not recognized until the triggering event occurs because the violation is a current-period event.

However, proponents of View 4 believe that when there is a clawback of erroneously paid IBC, the conclusion that a material restatement is required is not the appropriate triggering event to recognize the clawback. Rather, the erroneously paid IBC is a direct effect of the error correction because it should never have been "received" by the employee in the first place since it was based on erroneous results (and would not have been received on the basis of the restated financial measures). That is, the return of erroneously paid IBC is (1) automatically triggered by regulation, (2) nondiscretionary, (3) objectively calculable with sufficient specificity (although some estimation and judgment may be required), and (4) directly related to the error correction. Under this view, the clawback would be recognized as a reduction of compensation cost in the appropriate prior periods that are being restated. The revised amounts would then be included in the revised summary compensation table in a manner consistent with the proposed table disclosure requirements discussed in Disclosure Implications above.

Opponents of this view believe that ASC 718 provides adequate guidance on how to treat clawbacks triggered by a material restatement.

[24] Refer to ASC 718-20-35-9.
[25] Refer to ASC 250-10-45-23.

Editor's Note: We do not believe that all of the above views are acceptable or that they are necessarily the only views to consider. Further, those views may change depending on the requirements of the final rule.

Although View 4 is not explicitly illustrated in ASC 718, we believe that it has merit because it matches the timing of the recognition of the restated financial measures with the reduced compensation cost associated with the IBC that resulted from material errors in previous financial statements. However, given that the different views could result in significantly different financial statement results, we expect dialogue to continue on the appropriate accounting to apply when there is a material restatement triggering clawback of IBC.

Tax Considerations

Companies may also want to consider the proposal's potential tax consequences for both the company and any executives of the company whose compensation is subject to clawback. Such consequences are discussed below.

Consequences for the Company

When amounts paid as compensation are required to be repaid to the company in the same calendar year, the company would not claim a tax deduction for the amounts that were subject to the clawback. If the company receives a clawback payment from one of its executives in a subsequent tax year, any tax deduction previously taken for the compensation that was subject to the clawback would be reversed to the extent of the repayment.

Consequences for the Company's Executives

In determining how to implement a clawback, the company may want to consider the tax consequences for its executives. When amounts paid as compensation are required to be repaid to the employer in the same calendar year, the repaid amounts are not considered income and are not subject to reporting. However, the consequences are different when amounts paid to an executive in one year are required to be repaid in a subsequent calendar year as a result of the clawback. In such a case, the amounts originally paid to the executive remain properly includable in the executive's income in the year received. Although the executive is entitled to a miscellaneous itemized deduction for the amount that must be repaid under the clawback, the deduction may not be available in practice since it is subject to the requirement that miscellaneous itemized deductions are only deductible to the extent that they exceed 2 percent of adjusted gross income (the "2 percent floor").

Section 1341 of the Internal Revenue Code (IRC), which codifies the "claim of right" doctrine, permits an alternative basis for claiming a deduction. If Section 1341 applies, the taxpayer is entitled to a deduction based on the decrease in tax for the year of inclusion that would result solely from exclusion of the item from gross income. In addition, such an amount is not subject to the 2 percent floor. The key issue in the determination of whether Section 1341 applies is whether there appeared to be an unrestricted right to the amount. Answering this question requires analysis of the facts and circumstances. Accordingly, determining whether Section 1341 applies to a clawback situation will require executives and their advisers to review the terms of the payment, the clawback requirements, and other facts related to the repayment. The alternative is to structure payments as deferred compensation so that payment is made after the clawback period lapses. Although this approach avoids the tax complexities of repayment, it is a change to the underlying arrangement that introduces the complexities of the deferred compensation rules under IRC Section 409A.

Next Steps

Since the proposal requests comments on virtually all aspects of its provisions, companies will have the opportunity to express their concerns and recommend improvements or alternatives by submitting comments to the SEC before the September 14, 2015, deadline.

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