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The balance between compensation and sustainable performance is a tough one for directors. Clawbacks are rising in popularity as a way to keep both executives and stakeholders happy, but directors should realize they are fraught with complexities.

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The federal government wants to raise business taxes. The IRS wants more information from companies. How might these proposals impact your company?

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In a recent survey, directors gave low marks to their effectiveness at management succession planning. That's clearly not optimal, given the level of CEO turnovers. What should boards be doing?

# Executive compensation arrangements—The rise of the clawback

Many companies are changing their compensation plans to better align pay with long-term performance. One approach some companies have been considering is greater use of clawback provisions. Such provisions allow companies to reclaim previously awarded compensation if circumstances later indicate the compensation might not have been truly earned.

Some clawback features have long been part of compensation arrangements—indeed, Sarbanes-Oxley called for clawbacks of CEO and CFO compensation in the case of restatements. Many companies have “noncompete” clawbacks, which require an employee to return some amount of compensation if he or she leaves to work for a competitor. Other actions that commonly trigger clawbacks include fraud, malfeasance, and the violation of a nonsolicitation agreement (prohibiting an executive from bringing other employees along to a new employer).

**Potential new clawbacks:** Companies are developing contracts with new clawback provisions to address

- Conduct that is detrimental to the company
- Actions that result in restatement of the financial statements or other financial harm to the company
- Whether expected profits have actually been achieved, when considered in hindsight against performance-based measures
- Other factors that, in the discretion of management or the compensation committee, represent improper behavior

These new provisions are intended to help companies better align compensation and risk. However, there are a number of challenges in implementing clawbacks. Because some of these clawback provisions are vague, it may be difficult to determine whether they've been triggered.

Even when a provision has clearly been triggered, it might not always be clear who triggered it. For example, if a company needs to restate its financial statements, it might not be obvious whether the clawback would apply only to the individual who directly caused the restatement, or should also apply to that person's supervisor(s) who failed to catch the error.

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## Federal tax policy update

The taxation of corporations continues to be in the spotlight in these challenging economic times.

### The 2011 federal budget

The Obama administration's proposed federal budget contains more than \$400 billion in business tax increases, which would roll out over the next 10 years. This includes tax changes to US companies' business activities outside the United States. It is estimated that the latter would raise approximately \$122 billion by:

- Limiting US companies' ability to use foreign tax credits to avoid double taxation
- Deferring deductions for a portion of interest expense
- Immediately taxing certain foreign earnings that are attributable to intangible assets transferred from the United States to lower-tax countries

Nearly half the income of US multinationals is earned by their foreign affiliates. These proposed changes would create significant challenges for US companies that compete in global markets, as US multinational companies would pay more income tax than competitors based outside the United States.

The budget also proposes a number of general revenue raisers that would impact business, such as levying a "financial responsibility crisis fee" on financial institutions and

insurance companies, judicially disallowing tax transactions that lack economic substance, and eliminating the use of the last-in, first-out (LIFO) inventory method for tax purposes.

The prospect of legislative action on these proposals this year is uncertain. Some key members of Congress want significant changes in tax rules for US multinationals to be considered only in the context of a broader tax reform debate. If the proposed increases in business taxes are characterized as closing "loopholes" and reducing "corporate welfare," they could be used to pay for other economic and social priorities such as job creation, meaning that the additional tax revenue would not be available to pay for fundamental tax reform.

Rising concern over significant federal deficits increases the likelihood that Congress may consider additional revenue-raising proposals affecting the business community. In early 2010, President Obama signed into law a permanent pay-as-you-go (PAYGO) measure. The new statutory PAYGO requirement could increase the pressure to include revenue offsets in legislation under consideration this year. If passed, such legislation could put at risk the extension of the research credit and other expired tax incentives, making it more difficult to extend certain tax relief in the future.

### Increased IRS focus on uncertain tax positions

A new IRS proposal would require most companies—those with assets over \$10 million—to disclose as part of their income tax returns specific information about "uncertain tax positions."

What would change? A company would be required to describe each uncertain tax position, the reason for the uncertainty, and the maximum amount of tax liability that would result if the position was not sustained. The proposal would apply to all uncertain tax positions for which a reserve is recorded and certain positions for which no reserve is recorded.

The IRS believes that it can ask for this under its broad discretion to request any information necessary to determine a taxpayer's tax liability. Nevertheless, companies are concerned that this initiative is the IRS's way of obtaining certain information contained in tax accrual workpapers without having to request copies of the workpapers themselves—an issue that is the subject of ongoing litigation in the case involving Textron.

In our view, the IRS's proposal raises broader public policy and tax administrative issues and should not be finalized without a full vetting among all interested stakeholders.

## Why succession planning belongs on the agenda

Directors rank management succession last in effectiveness in a list of seven core responsibilities according to the 2009 *What Directors Think* survey by PricewaterhouseCoopers and *Corporate Board Member* magazine.

In fact, a quarter of the directors surveyed say their companies have no management succession plan in place at all. And less than half of those surveyed rate their boards as effective in such planning.

Although directors clearly have other pressing issues on their minds, they cannot afford to overlook the importance of management succession. In a business environment where uncertainty continues to prevail, even planned leadership transitions can cause unease in the marketplace. And transitions aren't rare: Spencer Stuart noted that 10 percent of S&P 500 CEO positions turned over in 2009.

While boards might sometimes wish to look outside for talent—if, for example, the company is heading in a different strategic direction—succession planning should focus on internal candidates. Internal candidates already know the company's business, culture, and people, allowing for a smoother transition. Plus, they typically cost less than external candidates.

Focusing on internal candidates also demonstrates to employees that developing talent is a priority. So directors should seek insight into how senior management is developing high-performing managers, and whether those managers are getting the right kind of ongoing coaching, as well as the wide array of assignments that will help foster leadership skills.

These future leaders also need exposure to the board. This gives the board more insight into high-potential managers, allowing directors to assess the company's bench strength. It also allows up-and-comers the chance to gain insight into the board's role and objectives, and become comfortable interacting with the board.

Shareholder and market perception is another consideration. Shareholders clearly are interested in succession planning. Selecting an internal candidate signals to shareholders that the company is investing the time and effort to cultivate internal management, hence strengthening the organization. The SEC now allows shareholders to submit resolutions to demand more information about management succession plans.

Boards that aren't already holding regular, candid conversations about succession planning should add the topic to their agenda. Seamless leadership transitions occur only if boards view management succession as an ongoing responsibility, rather than a point-in-time exercise (e.g., a reaction to a sudden CEO departure). Having a new CEO is no excuse to postpone good planning. Indeed, management succession planning discussions ideally begin as soon as a new CEO takes over.

## Executive compensation arrangements

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Also, if clawbacks are to be tied to performance-based measures, the company will need to determine whether those measures will be based on the performance of individuals, business units, or subsidiaries. Assessing performance at the individual level may seem like the fairest approach, and it is certainly possible in some cases, say, for a trader in a financial services firm. In many cases, however, tracking such measures may be impossible or cost-prohibitive. Finally, since clawbacks entail recovering compensation that has already been awarded, enacting a clawback may result in litigation.

**Financial reporting considerations:** Accounting guidance for most clawbacks is generally straightforward. However, the new breed of clawback features may pose accounting challenges. For example, depending on the level of discretion or subjectivity built into the clawback, the accounting “grant date” of a stock-based compensation award could be delayed, possibly resulting in mark-to-market accounting until the grant date is established. And if the clawback could be considered a performance condition of the award (i.e., a prerequisite for earning the award), the recognition of the compensation expense could be altered, because the measurement date is unknown.

**Developing compensation arrangements that meet the needs of the company, the employee, and other stakeholders is a sensitive and complicated matter.** Although clawbacks can be an effective way of reinforcing the link between pay and long-term performance, they should not be relied on exclusively. After all, for a clawback to take effect, something bad has to have happened. So consider supplementing them with other measures, making them just part of an overall strategy to incent long-term growth.

### How PwC can help

To have a deeper discussion about how these subjects might affect your business, please contact:

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### You may also want to read

The 2010 edition of *Current Developments for Directors* is available to help directors understand important developments and their impact on your companies and what you do in the boardroom. Key areas of focus in the current edition include the economy, governance changes, global tax issues, financial reporting, and regulatory developments, as well as a special focus on government involvement in business.

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