

# THE SEVEN STEP PROCESS TO A MORE EFFECTIVE NONQUALIFIED DEFERRED COMPENSATION PLAN

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Companies of all sizes in all sectors have spent a great deal of time recently reviewing their executive benefits. In addition to salary, annual bonuses and long-term compensation, executive benefits are now seen as one of the four key components to executive pay. The unprecedented attention to reviewing a company's executive benefits is driven by several factors, including the following:

- The passage of The American Jobs Creation Act and the resulting IRC 409A compliance regulations
- Much greater scrutiny of executive benefits in the post-Sarbanes-Oxley area
- The reduced appeal of stock options in light of expensing requirements
- The desire to create creative low-cost executive benefits plans that help recruit, reward and retain executive talent in a more mobile society.

As a result of these factors, virtually all of corporate America is reviewing its existing nonqualified executive benefits plans. In addition, companies that do not offer some form of nonqualified plan are considering the implementation of a plan due to an executive's inability to create wealth through the company qualified retirement plan as a result of 401(a)17 and 415 plan limits.

According to Clark Consulting's *Executive Benefits – A Survey of Current Trends*, which reflects data compiled from more than 20 percent of *Fortune*

1,000 companies, the prevalence of non-qualified deferred compensation (NQDC) plans has increased significantly over the years. Based on 2005 results, 91 percent of survey respondents utilize an NQDC plan, versus 60 percent that offered them in 1993, the first year the survey was conducted. The increase in nonqualified plan prevalence and the need to review existing plans begs the question: What is the best process that a sponsoring company can follow to most effectively address existing plan issues or develop new plans?

By following a seven-step process, ideally executive performance will be improved and executive retention enhanced. In addition to this process, it also is important to interview a select or random group of executives, via an executive benefits questionnaire, to help management better understand the needs and desires of its executives.

## Step One: Discussion of Objectives and Design Issues

Any executive benefits program also should enhance the company's ability to achieve its corporate business objectives. For this reason, the first step in the project is to clearly identify the company's specific goals and objectives for establishing, redesigning or implementing a nonqualified deferred compensation program. Once such

QUICK LOOK
⇒ The “nonqualified plan team” should be comprised of individuals from human resources, finance and legal, as each is impacted by nonqualified plans.
⇒ Once the proper balance among financial priorities is determined, the specific parameters for the analysis of funding alternatives can be prescribed.
⇒ The account team, consisting of an account manager, a benefits analyst and a financial analyst, will meet with the sponsoring companies' HR representatives assigned to this plan to discuss the ongoing service requirements.

goals are identified, they must be reviewed to be certain they are consistent with and support the overall corporate business strategy.

A specific group of management personnel who will be responsible for clarifying the company's objectives and making decisions on what actions are necessary to meet those objectives should be selected. This “nonqualified plan team” should be comprised of individuals from human resources, finance and legal, as each is impacted by non-qualified plans.

It also is during this step where the input from any of the individual executive interviews is communicated to the team.

After background information has been gathered it is important to review the impact of current proposed regulations, as well as current tax, legal, accounting and regulatory (e.g., SEC) environment on nonqualified executive benefit plans.

## Step Two: Preliminary Design of the Plan

Step two requires that a preliminary outline of the proposed program's plan design be developed based on the objectives agreed upon in step one. The plan will be reviewed in light of supporting rationale and cost implications to the company. The proposed plan's financial

impact, including the impact to corporate cash flow, profit and loss, and the balance sheet, should be discussed. It is also critical to discuss any potential administration and legal challenges.

### Step Three: Security Issues

This step involves a benefits security analysis, as well as a discussion around the various security devices available.

The focus during the benefits security analysis will be to provide the desired level of security through a combination of security devices and plan-design features that will address the level of benefits protection desired and the impact from the following events:

- Change of management
- Change of heart
- Change of financial condition (short of bankruptcy)
- Bankruptcy.

### Step Four: Funding Analysis

Step four begins with striking the right balance among the following financial priorities:

- Internal rate of return
- Asset/liability risk management
- Cash flow
- Liquidity
- Financial statement impact
- Crediting rates on deferrals
- Coordination with other benefits.

There are a wide variety of funding tools available for nonqualified plans today. Once the proper balance among financial priorities is determined, the specific parameters for the analysis of funding alternatives can be prescribed. Some of the different funding approaches to review include pay as you go (i.e. no funding), taxable strategies and tax-advantaged strategies.

The cost efficiency of the approaches will be impacted by the nonqualified plan-crediting rate, corporate tax bracket and company discount rate.

### Step Five: Recommendations

At this point, the final plan design will be determined and approved by the company's nonqualified plan team and management. The final recommendation will be based on the objectives expressed in step one and the decisions expressed in the subsequent three steps. If necessary, a board overview or a full presentation will be created to secure board approval.

### Step Six: Implementation

Specimen plan documents will be introduced for the plan(s) during this step. The company's outside legal counsel should review these documents. Additionally, plan-enrollment materials will need to be developed, including the following:

- Instructions for enrollment
- Plan summary
- Election forms
- Beneficiary designation forms
- Plan document
- Benchmark funds for plan-investment options.

The type of enrollment meetings required will need to be determined based upon the location of eligible executives, as well as the company's philosophy regarding enrollment. Options include on-site, teleconference and/or Web-based conferences.

### Step Seven: Plan Administration

Step seven requires that an account team from the plan administrator be assigned to the plan. This account team, consisting of an account manager, a benefits analyst and a financial analyst, will meet with the sponsoring companies' HR representatives assigned to this plan to discuss the ongoing service requirements, which include the following:


- Employee benefits statements and reports
- Employer reports
- Account history

- Participation communications
- Legislative and regulatory issue monitoring.

Lastly, annual reviews are necessary to ensure the plan is meeting the sponsoring company and executive objectives.

### Conclusion

Following this seven-step process is necessary in order to achieve management's objectives and to be sure the new or redesigned NQDC plan will be fair and appropriate for shareholders and the eligible plan participants.

Depending upon the availability of the company's nonqualified plan team, this entire process can take several weeks or several months, if not longer. However, the resulting plan design or redesign, security measures, funding and administration will result in an efficient and effective NQDC program that best meets all of the plan's objectives. This process is invaluable to companies looking to create a nonqualified program that will aid in the recruitment, rewarding and retention of a company's executive talent while remaining fair for shareholders. 

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