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The Magazine of WorldatWork

162(m), the Museum of Unintended Consequences

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Despite, or perhaps, because of, Section 162(m), top executive compensation has increased dramatically since 1993.

As a means of using the tax code to reduce excessive nonperformance-based executive compensation, Congress added Internal Revenue Code section 162(m) to the Revenue Reconciliation Act of 1993. Section 162(m) limits the corporate tax deduction for executive compensation to $1 million per individual for the top five executives of a corporation, providing an exception for compensation in excess of $1 million if it qualifies as "performance-based." Many experts have questioned whether this is actually effective. Recently, I testified before the Senate Finance Committee and suggested alternatives, which are outlined below.

Has 162(m) Been Effective?

Despite, or perhaps, because of, Section 162(m), top executive compensation has increased dramatically since 1993. Authors David Harris and Jane Livingstone, in a 2002 issue of *The Accounting Review,* suggest that inadvertently, section 162(m) may have encouraged some increases in cash compensation for executives earning less than $1 million. In unpublished research, David Ryan and I find that section 162(m) has also resulted in increases in stock option compensation for executives earning more than $1 million in cash compensation. In discussing the effect of Section 162(m) on the increased use of stock options, a recent *Wall Street Journal* article quoted Christopher Cox, chairman of the Securities and Exchange Commission (SEC), as saying it deserves a "place in the museum of unintended consequences."

Current Congressional Suggestions

One suggestion, brought up by Sen. Charles Grassley (R-Iowa), chairman of the Senate Committee on Finance, was to simply deny deductions for compensation in excess of $1 million. Of course, it is unlikely that denying deductions would reduce executive pay; Jennifer Yin and I show in a 2005 issue of *The Journal of Accounting and Public Policy* that corporations have demonstrated a willingness to forfeit deductions because of Section 162(m), and would likely continue to do so. Nor would denying deductions attain the goal of tying pay to performance.

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The losers in both scenarios would be the shareholders, and indirectly, the capital markets and our economy as a whole.

My Suggestions

The ultimate legislative solution depends on the desired goals. If Congress wants to raise tax revenue, then eliminating the performance-based exception would achieve that goal. If, however, Congress wants to discourage high pay, or more appropriately, high pay that is not based on performance, then a more nuanced approach is required. My proposals expand upon the approach the SEC has taken with respect to increased transparency in executive compensation disclosures as follows.

1. To qualify for the performance-based exception, require companies to provide increased disclosure of details in plans submitted for shareholder approval.

To qualify as performance based under Section 162(m), corporations have to obtain shareholder approval of their bonus plans. While ostensibly the plans presented to shareholders have to disclose their material terms, in reality they do not. In practice, the disclosures are so vague that they are meaningless. Shareholders are asked to, and usually do, approve performance plans without knowing thresholds, targets and parameters to be used in the calculation. Most educated individuals would never sign a contract that omitted such important details—why should shareholders be asked to approve compensation plans with such a paucity of detail? The following example is from a plan presented to shareholders for their approval.

- Within 90 days after the commencement of a performance cycle, the compensation committee will fix and establish in writing (A) the performance measures that will apply to that performance cycle; (B) with respect to performance units, the target amount payable to each participant; (C) with respect to restricted units and restricted stock, the target vesting percentage for each participant; and (D) subject to subsection (d) below, the criteria for computing the amount that will be paid or will vest with respect to each level of attained performance. The committee will also set forth the minimum level of performance, based on objective factors, that must be attained during the performance cycle before any long-term performance award will be paid or vest, and the percentage of performance units that will become payable and the percentage of performance-based restricted units or shares of restricted stock that will vest upon attainment of various levels of performance that equal or exceed the minimum required level.

In this example, which is not unique, shareholders are told that the compensation committee will establish performance measures, target payout and the criteria for computing the payout and vesting, but are not told what these criteria or formulae are. Disclosure of these details would allow shareholders to evaluate if thresholds for performance are adequate. In other words, allow them to determine if pay was not for performance, but for adequate performance. I believe requiring this disclosure will increase the link between pay and performance, as directors and executives would be less likely to set low standards. And shareholders, now in possession of the material facts, would be less likely to approve those plans with low performance standards.

2. To qualify for the performance-based exception, require that options be market adjusted, so that the executive would only benefit if the company's share price outperformed the market index.

Under Section 162(m) stock options were de facto assumed to be performance-based, as long as they were not in the money at the time of grant, and a plan was approved by shareholders. In reality stock options are pay for performance with a threshold of zero. That is, any increase in a company's stock price increases the value of an executive's stock options, even if the company underperforms the market, its industry index or even risk-free

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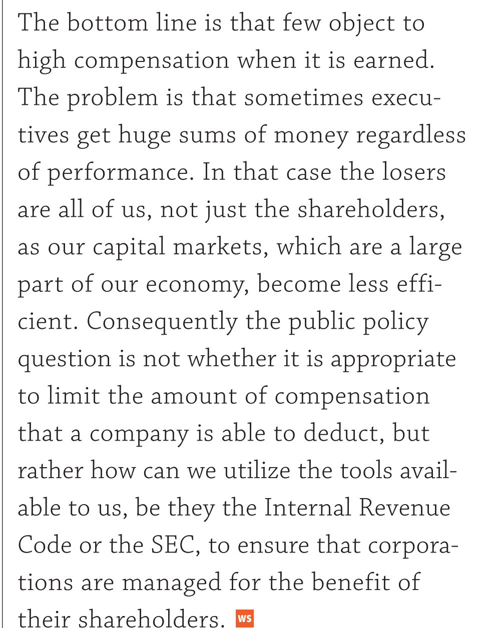
investments such as treasury securities. Even something as seemingly innocuous as frequent grants ensure that executives benefit from the fluctuating share prices without shareholders seeing any increase in long-term value. And this is without even manipulating the system via things like backdating and springloading. Consider the following example:

> On Jan. 1, 2010, and each year thereafter, the CEO of XYZ Corp. is granted options, exercisable over 10 years, to purchase 1 million shares at the current market price on the date of grant. The exercise price of the grants fluctuates with the market price, which was $35 on Jan. 1, 2010, $20 on Jan. 1, 2011, $30 on Jan. 1, 2012 and $40 on Jan. 1, 2013. As of Jan. 1, 2013, the CEO has options to purchase 4 million shares with an intrinsic value of $35 million. In contrast, the shareholder who owned the shares on Jan. 1, 2010, earned appreciation of a little more than 14 percent on those shares, less than he or she could have earned with U.S. Treasury Securities.

While this is a fictional example, truth can sometimes be stranger than fiction. The existence of share grants that sometimes even exceed 1 million shares, also known as mega grants, leads to the scenario where the executive can make a multimillion-dollar profit from subpar performance.

3. Require numerical disclosure of actual deductions forfeited and additional taxes paid. Currently companies discuss forfeiture of deductions in their proxy statements but are exceedingly vague. For example, one major corporation in its most recent proxy statement wrote, *"A significant portion* of the company's executive compensation satisfies the requirements for deductibility under Internal Revenue Code Section 162(m)." Other companies, while paying their top executive(s) salary far in excess of $1 million, give no indication of whether they forfeit deductions or not.

Disclosure of the numerical amounts involved would allow shareholders to evaluate if amounts are material. It would also put the onus on directors to justify forfeiting deductions and paying additional taxes, which I believe would make them less likely to do so.



Final Thoughts

The bottom line is that few object to high compensation when it is earned. The problem is that sometimes executives get huge sums of money regardless of performance. In that case the losers are all of us, not just the shareholders, as our capital markets, which are a large part of our economy, become less efficient. Consequently the public policy question is not whether it is appropriate to limit the amount of compensation that a company is able to deduct, but rather how can we utilize the tools available to us, be they the Internal Revenue Code or the SEC, to ensure that corporations are managed for the benefit of their shareholders. WS

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