Pay Governance®
Advisory Services to Compensation Committees

Viewpoint on
Executive Compensation

Opinion Research Alert

FASB Eliminates "Extraordinary Items" Concept — Implications for Incentive Compensation Plans

By John Ellerman and Bentham Stradley

Partners

Aubrey Bout
Chris Carstens
John R. Ellerman
John D. England
R. David Fitt
Patrick Haggerty
Jeffrey W. Joyce
Ira T. Kay
Donald S. Kokoskie
Diane Lerner
Eric Marquardt
Jack Marsteller
Richard Meischeid
Steve Pakela
Lane T. Ringlee
John Sinkular
Christine O. Skizas
Bentham W. Stradley
Jon Weinstein

Introduction

The Financial Accounting Standards Board (FASB) has elected to eliminate the concept of extraordinary items under Generally Accepted Accounting Rules (GAAP), effective with fiscal years beginning after December 15, 2015. The objective of this change by FASB is to simplify income statement presentation requirements in Subtopic 225-20 (Income Statement – Extraordinary and Unusual Items). In effect, the term "extraordinary items" will disappear and no longer exist. This change in terminology may have an impact upon a company's incentive compensation plans and potential compliance with Internal Revenue Code 162(m) requirements as a performance plan and/or listing standards under a particular stock exchange.

Nature of the Terminology Change

Under GAAP, the concept of extraordinary items as a defined term includes the requirement that the extraordinary item be an event or transaction that is *both* unusual and infrequent. Items that meet these requirements were segregated and reported separately in the income statement. Going forward, items need only be considered unusual *or* infrequent in order to qualify for separate reporting on the income statement.

FASB believes this change will provide greater transparency and clarity in financial reporting while continuing to provide stakeholders useful information about non-ordinary items. However, with the reduced standard (unusual *or* infrequent), there is the potential for an increased number of items being classified as Unusual or Infrequently Occurring, since they now must only meet one of two conditions.

Implications for Incentive Compensation Plans

Many companies have annual and long-term incentive compensation plans that have been implemented to comply with the performance plan requirements of Section 162(m) and/or to satisfy the listing requirements of a particular stock exchange. Plan documents, grant agreements, and compensation committee resolutions that specify the measurement and potential adjustments to specific financial performance measures may need to be revised to reflect the new accounting language adopted by the FASB. Whether such changes will be required will in large part be based upon the specificity with the language imbedded in the particular document and the explicit reference to extraordinary items and adjustments thereto.

For example, a company may have an incentive plan document that includes a provision similar to the following example: "The Committee is authorized to make adjustments in calculating the attainment of performance goals in recognition of (i) extraordinary items; (ii) changes in tax laws: (iii) changes in accounting principles; (iv) changes related to restructured or discontinued operations; (v) restatement of prior financial results; and (vi) any other unusual, non-recurring gain or loss that is separately identified and quantified in the company's financial statements." In this example, we would anticipate that company make a change to (i) above by deleting reference to extraordinary item and substituting language such as "items of an unusual nature or of infrequency of occurrence or non-recurring items." Such a change in plan language would not create any unintended consequences or potentially jeopardize the tax deductibility of compensation under Section 162(m).

When assessing performance under active performance cycles, committees will need to be mindful whether any proposed measurement adjustments meet the former Extraordinary and Unusual Items (requiring the item to be both unusual and infrequent), or the new guidance, which only requires that the item be unusual or infrequent. While these differences may be subtle, they could have significant implications for the amount of any earned awards – and also impact qualification of the awards under Internal Revenue Code 162(m).

Consult with your Auditor and Counsel

Pay Governance LLC recommends that companies confer with their auditor and tax counsel for further guidance and assistance in reviewing and amending plan documentation, as well as administrative matters associated with active performance measurement periods.

Questions about this Viewpoint can be directed to John Ellerman or Bentham Stradley by email at john.ellerman@paygovernance.com or bentham.stradley@paygovernance.com.