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FASB Drops Extraordinary Item Reporting: Section 162(m) Impact

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Some performance-based compensation awards that are exempt from the Section 162(m) $1 million deduction limitation are calculated by excluding items of gain, loss or expense that are within the FASB definition of "extraordinary events." The use of an established FASB standard to calculate an award prevents it from being considered subject to the application of positive discretion, which could increase the award. A right to use positive discretion nullifies the exempt status of an award.

In October, FASB agreed to drop the segregation, separate reporting and strict definition of extraordinary items. Accordingly, except as provided through the effective date provision, companies will no longer need to segregate on the income statement those items that are currently defined as extraordinary.

The FASB change might have no impact on so-called negative discretion or umbrella performance bonus plans. However, where performance bonuses are strictly based on performance metrics with limited or no application of negative discretion, consideration should be given to whether the typical wording of awards payable to executives whose compensation is subject to the deduction limitation needs to be revised.

In these latter instances, the bonus awards might be currently worded to exclude income or expenses resulting from extraordinary items, as determined in accordance with standards established by *Topic 225-20 Extraordinary and Unusual Items* of the FASB Accounting Standards Codification. If an award is calculated by the exclusion of FASB extraordinary items, the elimination of that terminology means that such FASB standard would no longer be applicable. In practice, the extraordinary item category was usually a catchall (following the listing of other excluded events) and was probably very seldom applied.

Although the extraordinary item definition will disappear, FASB retained the requirement that a material event or transaction that the corporation considers to be either of an unusual nature or of a type that indicates infrequency of occurrence (as both such terms are used under a more relaxed FASB definition) must be reported as a separate component of income from continuing operations. These events are disclosed on the income statement or in the notes to the financial statements. Having awards state that their calculation will exclude adjustments for events that are unusual in nature **or** infrequent in occurrence as reflected on the income statement in accordance with the FASB standard can continue to be used. Some arrangements already incorporate this standard, along with a listing of other specific excluded events.

In general, the FASB revision is expected to be effective for annual periods beginning after December 15, 2015, with some refinements. The final version of the standard should be available in December.

The following are examples where consideration can be given to whether any revision should be made to the wording of awards based on the FASB rule:

1. For future awards, consideration should be given to using the unusual or infrequent reference to adjust compensation structures to be exempt from the Section 162(m) compensation deduction limitation.

2. For multi-year awards that straddle the effective date and reference only the current extraordinary

event standard, the award terms should not be revised and caution should be used in applying the extraordinary event standard for years following the effective date of the FASB change.

3. In some cases, it might be appropriate to retain the reference to extraordinary events for at least a few future awards and also include the reference to unusual or infrequent events. This suggestion is made for those limited situations where prior extraordinary events trigger continuing disclosures under the final effective date of the FASB change.

Before revising future awards, consideration should be given to the types of events that could be considered unusual or infrequent under the relaxed standard. A corporation might not want to exclude from the income statement those consequences of non-recurring events that would otherwise increase the maximum bonus awards payable.

Negative Discretion Plans. For those employers that utilize "so-called negative discretion" or "umbrella" plans, the FASB revision might not have any impact. In these arrangements, extraordinary event adjustments might be used in the exercise of negative discretion to reduce the award payable. Negative discretion can be used with great flexibility for Section 162(m) purposes and so the FASB change should generally not be an issue under these arrangements. However, because the standard would no longer be used, consideration should be given to identifying the appropriate standard to apply to implement negative discretion.

The one exception to this general rule that there is no impact on negative discretion plans is where the extraordinary event adjustment is used in the calculation of the upper limit of the award payable. In that situation, consideration should be given to changing the standard used to calculate the upper limit based on the FASB revision.

FOR MORE INFORMATION

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