



Navigating the SEC's

Incentive Based Compensation Clawback rules

January 24





Executive Summary

In 2023, US securities exchanges adopted listing standards in compliance with the final rules introduced by SEC in 2022. The aim is to ensure that listed companies take back excess compensation when there are errors in their financial reporting, in matters related to accounting revisions or restatements. This requirement applies to most listed companies, with only a few exceptions.

Here's what these final rules require:

Companies need to create and put into practice a policy for recovering incentive-based compensation that was given to both current and former executive officers based on materially misreported financials.

They also have to publicly share this recovery policy as an exhibit to their annual report, including information about any instances where compensation was recovered along with other disclosures.



The primary objective behind these rules is to ensure that executive officers don't retain excessive compensation if the financial results used to determine their pay are later found to be incorrect due to significant violations of financial reporting standards.

The issuer's recovery policy would only apply to incentive-based compensation received on or after the effective date of the new rules (i.e., October 02, 2023). The affected issuers must adopt a recovery policy that complies with the standards no later than December 01, 2023.



Recovery policy will also apply to incentive based compensation received pursuant to pre-existing contracts or arrangements entered before October 02, 2023.

Entities and Securities governed by the Regulation

Applicability of Listing standard



*Certain security futures products, standardized options, securities issued by unit investment trusts, and securities issued by certain registered investment companies are exempted from mandated listing standards.

Accounting Restatement Triggers for a Compensation Recovery Analysis

A compensation recovery analysis would be triggered if an issuer is required to prepare an accounting restatement due to the issuer's material non-compliance with any financial reporting requirement under the securities law. Such restatements would include to correct an error:

- In previously issued financial statements that are **material**¹ to the previously issued financial statements (a “**Big R**” restatement), or
- That would result in a material misstatement if the error were corrected in the current period or left uncorrected in the current period (a “**little r**” restatement)



If the error is not material to the prior or current period financial statements, the error does not trigger the recovery policy.

¹ The Commission did not propose further clarification regarding when an error would be deemed material for the listing standards under proposed Rule 10D-1. This is because assessing materiality involves analyzing specific facts and circumstances, a determination that has already undergone thorough scrutiny in both judicial and regulatory contexts.

The SEC has made it clear that an error issued in previously issued financial statements which has been corrected in the current year financial statements, commonly referred to as **out-of-period adjustment**, will not trigger a compensation recovery analysis as:

- The error is immaterial to the previously issued financial statements, and
- Also, the correction of an error is immaterial to the current period

The recovery provisions **will not trigger** when the changes to the issuer's financial statements do not represent error corrections. For instance, the following types of changes do not require compensation recovery:

- 1 Retrospective application of a change in accounting principle;
- 2 Retrospective revision to reportable segment information due to a change in the structure of an issuer's internal organization;
- 3 Retrospective reclassification due to a discontinued operation;
- 4 Retrospective application of a change in reporting entity.

Incentive Based Compensation (IBC)

For the purpose of the new rule, we need to understand what is meant by incentive-based compensation. It is any compensation that is granted, earned, or vested upon attainment of a financial reporting measure. In other words, any form of compensation that the executive officer gets when a specific financial goal as outlined in the company's financial reports is achieved. IBC is deemed to be 'received' when the financial reporting measurement goal is **'attained'** and not when the award is granted, issued, or paid. The following are some illustrative examples of IBC provided to executive officers based on the satisfaction of a financial reporting measure performance goal.

Restricted stock, restricted stock units, stock options, and stock appreciation rights (SARs) that are granted or vested

Bonuses paid from a bonus pool

Proceeds received upon sale of shares acquired through an incentive plan

Non-equity incentive plan awards that are earned wholly or in part

Other cash awards

Financial reporting measures

The final rule outlines financial reporting measures to include:

- Measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements.
- Any measures that are derived wholly or partially from such measure determined above.
- Stock price and total shareholder return (TSR).
- Non-GAAP financial measures are within the scope of this definition as they are derived from the issuer's GAAP financial information.

Other measures, metrics, and ratios to the extent they are derived from the issuer's financial statements (e.g., average revenue per user) are also included in the definition. Financial information is included in this definition regardless of whether it is a part of the SEC filing or presented outside of the financial statements (e.g., in MD&A). The regulation provides the following instances (illustrative list) of **financial reporting metrics**:

- Revenues
 - Net income
 - Operating income
 - Profitability of one or more reportable segments in accordance with ASC 280
 - Financial ratios (e.g., accounts receivable turnover and inventory turnover rates).
 - Net assets or net asset value per share
 - Earnings before interest, taxes, depreciation and amortization.
- Funds from operations and adjusted funds from operations.
 - Liquidity measures (e.g., working capital, operating cash flow)
 - Return measures (e.g., return on invested capital, return on assets)
 - Earnings measures (e.g., earnings per share)
 - Sales per square foot or same-store sales, where sales are subject to an accounting restatement
 - Revenue per user, or average revenue per user, where revenue is subject to an accounting restatement
 - Cost per employee, where cost is subject to an accounting restatement
 - Any of such financial reporting measures relative to a peer group, where the issuer's financial reporting measure is subject to an accounting restatement and Tax basis income.



It is important to note that the new clawback rule does not apply to all forms of compensation, and the final rule also provides examples of compensation that is not considered incentive based compensation.

Levels of Executives in scope of the rules

The definition of “executive officer” provided in the final rules includes “the issuer's president, principal financial officer, principal accounting officer (or if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.”

“Further, the final rule clarifies the scope of the term 'Executive officer' as follows:
Executive officers of the issuer's parent(s) or subsidiaries are deemed executive officers if they perform such policy-making functions for the issuer. In addition, when the issuer is a limited partnership, officers or employees of the general partner(s) who perform policymaking functions for the limited partnership are deemed officers of the limited partnership. When the issuer is a trust, officers, or employees of the trustee(s) who perform policy-making functions for the trust are deemed officers of the trust. Policy-making function is not intended to include policy-making functions that are not significant.”

The above definition of “executive officer” is modeled on the SEC's definition of “officer” in Rule 16a1(f) of the Securities Exchange Act of 1934 and should, at a minimum, include all executive officers identified under Form 10-K, Item 10.

The final rule requires recovery of excess IBC received by a current or former employee: (1) after the employee became an executive officer, and (2) for the related IBC performance period in which the employee served as an executive officer.

Recovery of IBC received while an individual served in a non-executive capacity before becoming an executive officer will not be required. As a result, recovery sometimes may be required from individuals who were former executive officers as of the trigger date.

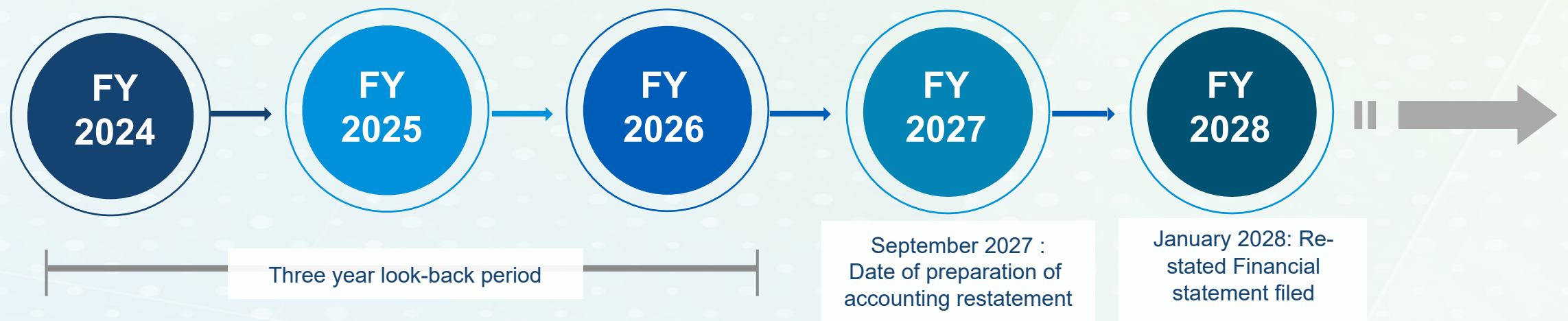
💡 As the rule applies to both current and the former employees, the issuer must keep an updated list of executive officers who served in at least three preceeding financial years.

Timeframe Addressed by the Compensation Recovery Policy

Once the date to prepare an accounting restatement is determined, recovery policy will cover the three completed fiscal years immediately preceding such date i.e., any compensation received during the look-back period will be subject to recovery.

- The date, an issuer is required to prepare an accounting restatement, is determined by earlier of the following events:
- The date the board of directors or the authorized officer (s) concludes, or reasonably should have concluded that the issuer is required to prepare an accounting restatement; or
 - The date a court, regulator or other legally authorized body directs the issuer to prepare an accounting restatement.

For example, if an issuer follows a calendar year and concludes in September 2027 that a restatement of previously issued financial statements is required and files the restated financial statements in January 2028, the recovery policy would apply to compensation received in the year ended December 31, 2024, 2025, and 2026.



An issuer’s obligation to recover erroneously awarded compensation is not dependent on if or when the restated financial statements are filed with the Commission.

💡 In situations where an issuer has changed its fiscal year-end during the three-year look-back period, the issuer must recover any excess incentive-based compensation received during the transition period occurring during, or immediately following, that three-year period in addition to any excess incentive-based compensation received during the three-year look-back period (i.e., a total of four periods).

Recovery Policy Framework




The executive officers who received more IBC than they should have on account of incorrect financial statements, within the three most recent fiscal years before a restatement, are required to pay back the excess compensation. Further, the policy creates a “**no-fault**” approach where they must repay erroneous IBC even if the restatement was due to an unintentional mistake.

To ensure the issuer recovers the full amount of erroneously awarded IBC, the calculation must be based on gross IBC without considering tax liabilities incurred or paid by the executive officer.

Let's examine how to calculate the recoverable amount in specific types of compensation plans.

- The excess **share-based awards** can be recovered in the following scenarios:
- If shares, stock options, or SARs are held by the individual at the time of recovery, the recoverable amount would be the excess awards beyond what they would have received if no restatement had occurred.
 - If stock options or SARs have been exercised, but the underlying shares were not sold, the recoverable amount would be the number of shares underlying the excess options or SARs after the restated financial measure has been applied.

 It's worth noting that even if the share-based payment awards have been sold, the "proceeds received from the sale of shares obtained through an incentive plan" may still be subject to recovery.

Board’s discretion to decide whether to pursue Recovery




The SEC acknowledges that there are situations which may not be in the best interests of the shareholders to go after IBC recovery. Therefore, the final rule specifies that the companies must reclaim mistakenly paid compensation unless:

- 01** The expenses associated with enforcing the recovery, such as reasonable legal fees, would exceed the recoverable amount,
- 02** Pursuing the recovery would violate the laws of their home country,
- 03** Recovery could potentially cause an otherwise tax-qualified retirement plan, that provides benefits to the issuer’s employees, to fail to meet the requirements under the Internal Revenue Code and regulations.

A company that gives out **cash-based bonuses** from a **bonus pool**. When they discover an error in their financial reporting, they must **recalculate the aggregate size** of that bonus pool using the corrected financial data. If the new pool size turns out to be smaller than the total bonuses already paid out, here's what happens:

- The extra amount given to executive officers is equal to the **same percentage reduction** in the bonus pool and
- Each executive officer's excessive payment is determined fairly based on a **proportional basis**.

 What's crucial to understand is that the final rule doesn't allow the company to pick and choose how much Incentive-Based Compensation (IBC) to recover from each executive officer – it has to be done consistently.

When it comes to **Non-qualified Deferred Compensation**, here's what happens to an executive officer's account balance or the money they receive:

- It gets reduced by the extra IBC that was put into the non-qualified deferred compensation plan. So, any excess IBC contributed will be taken out.
- It also gets reduced by any interest or earnings that were gained on those extra amounts. So, any extra money earned on that extra IBC is also taken away.

A reasonable effort should be made by a company to retrieve the excess IBC before concluding that the enforcement costs make it impracticable to recover any portion of the IBC as the final rule does not set a minimum limit. The issuer would also be required to document its efforts to recover such IBC and share the documentation with the listing exchange.

Before concluding that the company’s law violates the home country’s law, an issuer would first need to obtain an opinion from their home country’s legal counsel if the recovery results in violation of the home country's laws. Furthermore, any determination regarding the impracticability of recovery should be made by the company’s compensation committee. In the absence of the compensation committee, a majority of the independent directors on the company’s board should be involved.

Disclosures required by the Law



A listed issuer will need to file its recovery policy as an exhibit to its annual report and to provide other disclosures.

Annual report Disclosures

The final rule introduces changes to **Forms 10-K, 20-F, and 40-F** by adding **checkboxes** on the cover page. These checkboxes serve two purposes:

- ☒ to indicate if the financial statements in the filing have been corrected due to a prior error and
- ☒ to specify whether any of these error corrections involve restatements that necessitate a recovery analysis of IBC received by executive officers within the applicable recovery period.



It's important to note that when a restatement (i.e., "Big R" or "little r") occurs, the issuer is required to check both boxes, irrespective of whether excessive IBC was received by executive officers.

Disclosures about Executive Compensation in Annual Reports or Proxy Statements

The Final rule for listed issuers requires the following:

1. Disclosure of Compensation Recovery Policy: Listed issuers must disclose their compensation recovery policy as an exhibit in the annual report in Form 10-K, in accordance with of the listing standards.
2. Item 402(w) Disclosure Requirements: Issuers must disclose how the recovery policy was applied including the following information:
 - a. The **date of any accounting restatement** and **amount** erroneously awarded compensation linked to it.
 - b. Detailed **calculation of the recoverable amount** including **estimates and methodology** used in case the financial metric like stock price or TSR is involved.
 - c. The aggregate **amount of outstanding erroneously awarded compensation** at the end of the last fiscal year.
 - d. If recovery of erroneously awarded compensation is **overdue for 180 days or more** since the clawback amount determination, disclosure of names of executive officers and their respective outstanding amounts.
 - e. **If recovery is impractical**, disclose the **amount forgone** for each executive officer and provide a brief explanation of why recovery wasn't pursued, with additional information, such as:
 - Direct expenses paid to the third party for policy enforcement.
 - Any foreign law that the policy would violate.
 - Explanation of how the policy would impact tax- qualified retirement plans under IRS regulations.

Interaction with ASC 718

As per ASC 718, a clawback is treated as something that might happen in the future, so it's categorized as a contingent event. The accounting process for a clawback only comes into play when there's an actual compensation recovery event.

Here's how it works based on ASC 718:

- When the company gets back the compensation, they recognize the clawback. This means the issuer records a credit on the income statement, up to the initial expense recognized for an equity-classified stock award.
- At the same time, a credit to the additional paid-in capital for the fair value of the consideration in excess of the amount that had been initially recognized.

If the initial grant was a liability award, a similar accounting method is used. The key goal is to make sure that the total income recorded aligns with the final cost of the award. Any extra amount, if there is one, gets credited to additional paid-in capital.

One important thing to note is that clawbacks, because they're contingent events, don't immediately impact how stock-based compensation awards are initially measured. It only comes into play when an actual recovery event occurs.

For a more in-depth conversation, contact



Manik Bansal
Accounting Advisory
manik.bansal@pierianservices.com



Shubham Bindal
Accounting Advisory
shubham.bindal@pierianservices.com

Pierian | Assurance | Advisory

www.pierianservices.com

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