

# Section 162(m) Audit Techniques Guide (02-2005)

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**NOTE:** This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

Every publicly held corporation maintains its executive compensation records differently. Likewise, every publicly held corporation maintains different methods for compensating its executives. As the examining agent, you must first learn the identity of the individual(s) within the corporation who are most familiar with how the executive compensation records are maintained. You will need to have a general discussion with that person regarding the record maintenance and retention practices of the corporation with regard to executive compensation. This discussion will help you narrow the focus of your IDRs and will also familiarize you with in-house terminology that is utilized by the corporation when discussing and researching records concerning executive compensation.

The following is a non-comprehensive list of questions to ask in the initial interview:

1. How are compensation records for each executive maintained? For example, is there a centralized file for each executive, and does that centralized file reflect all forms of remuneration to the executive per year?
2. If centralized files per executive are maintained, what records should be contained within the file? For example, if an executive participates in four different compensation plans or programs, will the centralized file contain the written agreement and election forms with regard to the executive's participation in each of the plans or programs?
3. What records are available to reflect stock-based remuneration and how are they maintained? For example, if someone is granted stock options or restricted stock, are the grants evidenced by an Award Agreement or Grant Agreement? How does the corporation track exercises of stock options or the vesting of restricted stock grants? Is a centralized computerized data base used or does the corporation rely on paper documents?
4. At what level are grants of stock options and restricted stock made? For example, if an executive of a subsidiary is granted stock options, is the grant made at the subsidiary level, or at the parent level?
5. How is remuneration granted or awarded to an executive? For example, who or what determines the remuneration to be awarded an executive: the compensation committee, the Board of Directors, an executive contract?
6. Will all forms of remuneration be reflected in an executive's employment contract, or are there other methods by which remuneration can be awarded, such as an annual

incentive plan, yearly bonus pool, long-term incentive plan, stock option plan, restricted stock plan, phantom or restricted stock unit plan, etc.?

7. How are the compensation committee minutes maintained; do they include proposals, exhibits, attachments, resolutions, etc.?
8. Does the corporation provide phantom grants or awards, such as phantom stock or phantom equity?
9. If the corporation provides phantom grants or awards, how are phantom awards documented and tracked?
10. Does the corporation provide deferred compensation arrangements?
11. How are deferred compensation arrangements documented (i.e., via written agreements or election forms) and how are deferred amounts tracked by the corporation and/or executive (i.e., rabbi trusts, separate accounts, monthly statements)?
12. Does the corporation utilize the services of outside administrators, brokers, or consulting companies in the formation, administration and management of its various executive compensation plans or programs? If so, you will want to know who and what plans or programs they are connected with.
13. How are stock options and restricted stock grants exercised? For example, are they exercised directly with the corporation or through a broker or other third-party?
14. How are stock option exercises effected? For example, when an executive exercises stock options, does the executive receive the certificates evidencing the shares of stock upon exercise; does the executive have to pay the exercise price for the options exercised or does the executive have the option of a cashless exercise; does the executive have the option of receiving the difference between the exercise price and the fair market value of the stock in cash or other property?
15. Does the corporation have grant detail reports reflecting options granted, the grant number of the option, the dates of exercise of the options, and the fair market value of the stock as of the date of exercise? If so, how are these records maintained and are they available for individual executives?
16. Does the corporation provide split-dollar life insurance policies to any of its executives?
17. Does the corporation use acronyms, codes or other symbols to identify transactions, such as stock options that were granted as the result of a bonus plan? If so, you will want a copy of the list of acronyms and what they mean.
18. Does the corporation have a practice of deferring compensation that would otherwise exceed the \$1 million limit from years in which the recipient is a covered employee for purposes of § 162(m) to years during which the recipient is not a covered employee? If so, you will want to determine whether the deferred amounts were actually or constructively received by the recipient during an earlier year (when the recipient was a covered employee), resulting in a disallowance of the deduction (both for the year of payment and the year in which the amounts were constructively received). Also, if amounts are paid within 2 and ½ months after the end of a year in which the recipient

was a covered employee and such amounts accrued during that year, the deduction should be claimed for the year of accrual (and therefore should be subject to the § 162(m) limitation), not the year of payment (when the limitation would not apply).

19. Does the corporation have one or more qualified performance-based compensation plans that have been approved by its stockholders? If so, you will want to determine whether those plans are in compliance with § 162(m), both in form and operation.
20. Has the corporation made modifications to performance goals or targets after the beginning of the performance period to which such goals or targets relate? Are amounts being paid to covered employees whether or not the relevant goals and targets have been attained?
21. Which executives were listed on the corporation's summary compensation table in the corporation's annual proxy statement for the years at issue?

Once you have become familiar with the corporation's terminology and methods of tracking executive compensation, you will better be able to draft IDRs. You may need to issue more than one IDR, and if the information you receive in response to an IDR is incomplete, you will need to issue a follow-up IDR or a summons to obtain the missing information.