

## Nonqualified Deferred Compensation Not Just For The Big Corporations

*By Bruce J. McNeil*

The value of nonqualified deferred compensation plans and the benefits to be gained from such plans may not yet be fully appreciated or realized by cooperatives. These plans may play a key role in decisions regarding the compensation to be paid to attract or retain a key employee or employees, to provide additional retirement benefits for the key employee or employees, or to achieve certain and desired business objectives for which incentives may be provided to the key employee or employees. This article is intended to provide an overview of these arrangements.

### Nonqualified Deferred Compensation Arrangements

Nonqualified deferred compensation arrangements are contractual arrangements between the employer and the employee, or employees, covered by the arrangement. Such arrangements are structured in whatever form achieves the goals of the parties; as a result, they vary greatly in design. Considerations that may affect the structure of the arrangement are the current and future income needs of the employee, the desired tax treatment of deferred amounts, and the desire for assurance that deferred amounts will in fact be paid.

In the simplest form, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay a stated dollar amount at some point in the future. However, in most cases, such a simple arrangement does not meet the needs of the parties to the arrangement; thus, the typical nonqualified deferred compensation arrangement is more complicated and may involve a funding vehicle or other mechanism to provide a level of security to the employee.

A nonqualified deferred compensation arrangement may provide for the deferral of base compensation (i.e., salary), incentive compensation (e.g., commissions or bonuses), or supplemental compensation. The arrangement may permit

the employee to elect, such as on an annual basis, whether to defer compensation or to receive it currently, similar to a salary reduction or cash-or-deferred arrangement under a qualified employer plan. Alternatively, the arrangement may provide for compensation that is payable only on the occurrence of future events, not currently.

A nonqualified deferred compensation arrangement may be structured as an account for the employee (similar to a defined contribution or individual account plan) or may provide for specified benefits to be paid to the employee (similar to a defined benefit pension plan). Under an account structure, depending upon whether the arrangement is unfunded or funded, a hypothetical or actual account is maintained for the employee, to which specified contributions and earnings are credited. The employee may be permitted to participate in the investment of the amounts credited to the hypothetical or actual account. The benefits to which the employee is entitled are based upon the amount credited to the account. Under a defined benefit structure, the terms of the nonqualified deferred compensation arrangement specify the amount of benefits (or formula for determining benefits) to be paid to the employee.

### Top-Hat Plans

The structure of a nonqualified deferred compensation plan may be in many forms and certain types of arrangements are referred to by specific terms. A "top-hat plan" is a term generally used for certain nonqualified deferred compensation plans that are exempt from most of the substantive requirements of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The ERISA exemption applies to a plan that is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. ERISA does not provide statutory definitions of the terms "select group," "management," or "highly compensated employees," and the Department of Labor has not issued regulations defining those terms. Employees sometimes claim ERISA protection (e.g., vesting or funding) for the benefit under a nonqualified deferred compensation plan;

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however, most nonqualified deferred compensation arrangements are intended to fall under the top-hat exemption.

A top-hat plan is exempt from the ERISA requirements relating to participation and vesting, funding, and fiduciary responsibility. A top-hat plan is not exempt from the reporting and disclosure requirements or the administration and enforcement provisions of ERISA.

## Section 457 Plans

Another type of plan that is adopted by a governmental entity or a tax-exempt organization is an eligible deferred compensation plan which is governed by and described in Section 457 of the Internal Revenue Code (the "Code"). Generally, amounts deferred under a nonqualified deferred compensation arrangement of a tax-exempt employer are currently included in the employee's income unless the arrangement is an eligible deferred compensation plan described in Section 457 of the Code. The maximum annual deferral under such a plan is \$13,000 for 2004 (the maximum annual deferral that also applies to a plan governed by Section 401(k) of the Code), or the employee's total includible compensation, if less. In general, amounts deferred under a Section 457 plan may not be made available to a plan participant before the earlier of (1) the calendar year in which the participant attains age 70 1/2, (2) when the participant has a severance from employment with the employer, or (3) when the participant is faced with an unforeseeable emergency. Amounts deferred under an eligible deferred compensation plan of a tax-exempt employer are includible in the employee's income when paid or otherwise made available to the employee. Amounts deferred under a Section 457 plan of a tax-exempt employer must remain the property of the employer, subject only to the claims of the employer's general creditors.

If compensation is deferred under a plan of a tax-exempt employer that is not an eligible deferred compensation plan (an "ineligible plan"), the deferred amounts are includible in the income of a participating employee when the deferred compensation is not subject to a substantial risk of forfeiture, even if the deferred compensation is not funded. An ineligible plan is governed by and described in Section 457(f) of the Code. An ineligible plan has more flexibility with regard to the amount that may be deferred, but compensation deferred under the ineligible plan is includible in the gross income of the employee for the first taxable year in which there is no substantial risk of forfeiture of the right to such compensation. An employee's right to such deferred compensation is subject to a substantial risk of forfeiture if the employee's rights to full enjoyment of the deferred amount is conditioned upon the future performance of substantial services by the employee.

## Rabbi Trusts

A nonqualified deferred compensation arrangement is typically "unfunded" so that the deferred amounts are not includible in gross income until the amounts are actually or constructively received. However, the unfunded status of such an arrangement presents the risk that the employee will not receive his or her deferred compensation when due. Therefore, the question that arises is what sort of security can be provided for the employee without incurring current income tax consequences, i.e., without having the arrangement being considered funded for tax purposes.

An arrangement that has been developed to provide employees with a level of security is a "rabbi trust." A rabbi trust is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the event of the insolvency of the employer.

## In Summary

A nonqualified deferred compensation arrangement may be used to provide (1) supplemental retirement income for a key employee, (2) an incentive to a key employee to meet certain performance objectives, (3) to attract or retain a key employee to the service of the employer, and (4) a method of deferring compensation and the tax on such compensation to a fixed and determinable future date. A nonqualified deferred compensation arrangement may be a very useful and valuable compensation tool for a cooperative to provide incentives to a key employee or employees to perform services for the cooperative so that desired performance objectives may be achieved or to encourage a key employee or employees to remain with the cooperative.

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# The Role of the Audit Committee for a Non-Public Cooperative

By Robert G. Hensley

*Editor's Note: This is the third in a series of articles by the author on policies and procedures dealing with accounting and regulatory issues.*

The origin of the modern audit committee dates back to 1939 when the New York Stock Exchange recommended that public companies have an audit committee. The role of the audit committee has evolved over time, and now the Sarbanes-Oxley Act of 2002 ("SOX Act") requires public companies, including cooperatives that register their stock with the Securities and Exchange Commission ("SEC"), to have an audit committee. The SOX Act provides:

The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

The SOX Act does not require that private cooperatives (those that do not register their stock) have an audit committee. However, a recent survey by the National Association of Corporate Directors found that 80% of private companies have an audit committee. Frequently, the bylaws of a cooperative will contain a provision requiring an audit committee, or it may be that your lender has required an audit committee. In addition, following the passage of the SOX Act, most auditing firms are strongly recommending that private companies, such as private cooperatives, have an audit committee. Likewise, most auditing firms are applying the same audit standards utilized for public companies to private cooperatives, further blurring the line of what is required by law and what is viewed to be a "best practice."

In addition to federal requirements, there are state laws that have been recently adopted or are under consideration that would require an audit committee for a private cooperative. For example, a cooperative formed under Minnesota Statute 308B.445 is required to have an audit committee. California has adopted a state statute that mirrors some of the requirements of the SOX Act and has proposed legislation that would apply to private companies, including private cooperatives.

Once your cooperative has established an audit committee, the cooperative should adopt a charter or other policy outlining the function of the committee. Even if your cooperative does not have a separate audit committee, the Board as a whole is by default performing the function of the audit committee, and the Board should consider adopting an Audit Review Policy or other policy which essentially mirrors the charter that would be followed if the cooperative did have a separate audit committee.

## The Audit Committee Charter

The audit committee of a private cooperative should probably meet two to four times a year, or more often if dictated by special circumstances. The purpose of an audit committee charter is to outline the responsibilities of the audit committee so that committee members are clear on the task they are supposed to perform. In general, the audit committee is appointed by the Board to assist the Board in monitoring (1) the integrity of the financial statements of the cooperative, (2) the compliance by the cooperative with legal and regulatory requirements, and (3) the independence and performance of the cooperative's internal and external auditors. The audit committee charter should be written, and is usually 3 to 5 pages in length. The role of the audit committee can be broken down into several components, some of which are outlined below:

## Hiring the Independent Auditor

- Review the experience and qualifications of the auditing team
- Hire/recommend to the Board the hiring of the auditor
- Approve the retention of the auditor for any non-audit services
- Approve the fees paid to the auditor
- Consider/establish a policy rotating the lead audit partner

## Planning and Supervising the Independent Audit

- Meet with the auditor to review the planning and staffing of the audit
- Review with the auditor any significant risk exposures
- Inquire as to the auditor's view about whether management's choice and application of accounting principles is aggressive, moderate, or conservative
- Inquire as to the auditor's view about the clarity of management's financial disclosure practices

- Meet periodically in separate sessions with management and the auditor to discuss any matters the committee believes should be discussed privately
- Instruct the auditor that the auditors are ultimately accountable to the Board of Directors, through the audit committee
- Review the results of the audit with the independent auditor and management
- Review with the independent auditor any difficulties the auditor may have encountered and any management letter provided by the auditor (including the cooperative's response to that letter)

### Interaction with Management

- Meet at least annually with the chief financial officer (or equivalent)
- Obtain annual certifications from the CEO and CFO (or equivalent) that they have made appropriate financial disclosures to the auditor and the audit committee
- Review the cooperative's major financial risk exposures and the steps management has taken to monitor and control such exposures
- Review the audited financial statements with management
- Establish and periodically review a Whistleblower Policy
- Establish and periodically review a Code of Ethics

### Size and Composition of the Audit Committee

It is not unusual for a private cooperative to have the Board of Directors perform the function of the audit committee. However, the burden on the time of directors may require that the cooperative establish separate committees to divide the workload (e.g., compensation committee, member relations committee, audit committee). When a committee is created, the typical audit committee contains from three to five members. With respect to the composition of the audit committee, the SOX Act requires that a public company disclose whether or not the audit committee contains a financial expert. An audit committee for a private cooperative should be comprised of individuals with a range of talents, including members who:

- Have a financial background and relevant accounting expertise
- Are independent of management and are willing to ask probing questions
- Have relevant business experience

### Keeping Minutes and Reporting to the Board

It is important that the audit committee keep written minutes of its meetings. While the minutes do not need to be a verbatim transcript of every meeting, the minutes should reflect the identity of the people present, the nature of the items discussed, and the decisions reached by the committee. The audit committee, usually acting through the chair of the audit committee, may elect to make a verbal report at the periodic meetings of the Board of Directors. The verbal report should be recorded in the minutes of the Board meeting. Instead of verbal reports, many audit committees have elected to submit a written report to the Board of Directors so that the written report can be reviewed for completeness by all members of the audit committee prior to submission to the Board.

### Summary

Most cooperatives conduct an annual independent audit of their financial statements. Even in situations where the Board as a whole is responsible for hiring and supervising the auditors, the cooperative should have a written policy in place that governs how the audit is conducted. If the cooperative has formed a separate audit committee, the Board should establish an Audit Committee Charter so that the functions and expectations of the committee are clear. The adoption of a written charter also serves as a type of checklist for the audit committee during the course of the year. Adopting a written charter should add a level of consistency from year-to-year with regard to the tasks performed by the audit committee, hopefully leading to more consistent accounting and audit review practices.

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