EBS Executive Benefits Solutions

Non-Qualified Deferred Compensation Accounting Guide

Overview

The following is an overview of the accounting for a non-qualified deferred compensation program structured as a voluntary deferral plan, as well as for the assets associated with commonly used informal funding arrangements.

It is important to understand that the accounting for such programs and funding arrangements can be complex. There is no single source or authority that covers the accounting treatment - it is drawn from a variety of accounting pronouncements. In addition, because of the flexibility of plan design of NQDC programs, the accounting can vary based on the specific plan structure or provisions.

This guide has been prepared for illustration purposes only. Executive Benefit Solutions is an executive benefit consulting firm which does not provide legal, tax or accounting advice. A corporate plan sponsor should consult with its accounting, auditing and tax professionals to ensure proper accounting treatment.

Non-Qualified Deferred Compensation Plans
Compensation/Salary Deferral Accounting Guide

Fundamental Principles

1. ***Separate accounting for the plan liability and the related informal funding assets:*** Unlike a 401(k) or other qualified plan, the assets and the liability related to a NQDC plan are accounted for separately.

2. ***Transparency of the rabbi trust:*** From both an accounting and tax standpoint, the rabbi trust is transparent. The provisions of the trust offer important legal protections for plan participants, and there are plan administration implications, but the trust has little if any impact on the accounting and tax treatment. Therefore, no separate entries are shown below for transactions between the corporate sponsor and the trust.

3. ***Alternative accounting treatment:*** The accounting for certain informal funding assets and the related deferred tax accounts can vary depending on the facts and circumstances of the situation.

4. ***Proxy:*** A detailed description of the required disclosures related to a non-qualified voluntary deferral program is beyond the scope of this basic accounting guide. They are set forth in Item 402 of Regulation S-K. However in general, information regarding the plan is reported in the Summary Compensation Table and in a separate Non-Qualified Deferred Compensation Table for each of the Named Executive Officers and for certain other highly compensated employees. Those disclosures include; a narrative description of the plan, the amount of employee and employer contributions during the year, earnings credited to the participant's account during the year, distributions from the account and the year-end account balance.

Accounting for the Plan Liability

Participant Accounts

A voluntary deferral program is an "account balance" plan accounted for under ASC 715-70. It allows a participant to defer a portion of his or her pre-tax compensation until separation from service, or until a specified date in the future. Compensation deferred is credited to a deferred compensation liability account established in the name of each participant at the time the compensation would otherwise have been paid.

The employer may choose to make matching or discretionary performance-based contributions, which also would be credited to the participant's account when the compensation would otherwise be paid. Earnings are credited to the participant's account based on the performance of the notional investment funds or model portfolios to which the participant has allocated his or her account. And finally, the participant's account balance is paid at separation from service, or at the specified date in a lump sum or in annual installments, as elected.

The balance sheet liability for the plan sponsor is the aggregate amount of the participant account balances.

Example / Simplistic Assumptions

A participant, age 51 elects to defer her $50,000 bonus each year through age 64. The notional investment funds selected earn 6.5%. Upon retirement at age 65, the company will pay the balance in her account in 15 annual installments. The company is a C Corporation, it's marginal income tax rate is 38.5%, it is in a position to recognize deferred tax assets, and it is not subject to AMT. The names of the ledger accounts used below are generic and are used for illustrative purposes only.

Year 1 Deferral

	Debit	Credit	Statement Affected
Deferred Compensation Expense	$50,000		Income
Deferred Compensation Liability		$50,000	Balance Sheet
Deferred Tax Asset	$19,250		Balance Sheet
Deferred Tax Benefit		$19,250	Income

Since deferred compensation is not deductible to the company until taxable to the participant, a deferred tax benefit and a deferred tax asset are recorded related to the deferred compensation expense and liability.

Accounting for the Plan Liability

Year 1 Earnings Credited to Account

	Debit	Credit	Statement Affected
Deferred Compensation Expense	$3,250		Income
Deferred Compensation Liability		$3,250	Balance Sheet
Deferred Tax Asset	$1,251		Balance Sheet
Deferred Tax Benefit		$1,251	Income

First Year of Benefit Payments

Based on the assumptions above, the participant's account balance would grow to $1,159,108 at retirement. The annual installment payments would be $115,751 for 15 years (assuming the continuation of earnings credits at 6.5%).

	Debit	Credit	Statement Affected
Deferred Compensation Liability	$115,751		Balance Sheet
Cash		$115,751	Balance Sheet
Deferred Compensation Expense	$67,818		Income
Deferred Compensation Liability		$67,818	Balance Sheet
Current Income Tax Receivable	$44,564		Balance Sheet
Deferred Tax Asset		$44,564	Balance Sheet
Deferred Tax Asset	$26,110		Balance Sheet
Deferred Tax Benefit		$26,110	Income

To reflect the first installment payment, the related current tax benefit, and the continued growth of the account.

Salary Deferral Plans

Accounting for the Informal Funding Assets

The following illustrates the conceptual accounting for two commonly used informal funding assets – Mutual Funds and Corporate Owned Life Insurance(COLI).

Mutual Funds[3]

Initial Purchase

	Debit	Credit	Statement Affected
Investments	$50,000		Balance Sheet
Cash		$50,000	Balance Sheet

Growth of Asset Value

	Debit	Credit	Statement Affected
Investments[3]	$3,250		Balance Sheet
Ordinary Dividends		$1,600	Income
Realized Gain		$550	Income
Unrealized Gain[1]		$1,100	OCI[1]
Current Tax Expense	$717		Income
Current Tax Payable		$717	Balance Sheet
Deferred Tax Component of OCI[2]	$423		OCI[2]
Deferred Tax Liability		$423	Balance Sheet

Notes:
[1] If invested assets are classified as "Available for Sale" securities under ASC 320-10/FAS115, the unrealized gain is credited to Other Comprehensive Income. As a result, there may be a P&L mismatch between the accounting for the liability and the invested assets. However, if the expected holding period is such that the investments can be classified as "Trading Securities," then both realized and unrealized gains would flow through the P&L, eliminating the possible mismatch. This example reflects "Available for Sale" classification.
[2] Deferred tax accounting would follow the accounting for the unrealized gains – recognized in OCI in the case of "Available for Sale" treatment, or in the P&L in the case of "Trading" classification.
[3] Mutual Fund portfolio structured as follows:

	S&P 500	Mid/Sml Cap	Fixed Income	TOTAL
Asset Allocation	40.00%	30.00%	30.00%	100.00%
Gross Return	6.50%	8.00%	5.00%	6.50%
Invest Fees	0.00%	0.00%	0.00%	0.00%
Net Return	6.50%	8.00%	5.00%	6.50%
Ordinary Dividends/Short-Term G/L	2.00%	3.00%	5.00%	3.20%
Capital Gain Dividends/Long-Term G/L	2.00%	1.00%	0.00%	1.10%
Unrealized Gain (Calculated)	2.50%	4.00%	0.00%	2.20%
Qual Dlv as % of Ord Dlv's Avail for DRD	75.00%	25.00%	0.00%	

Accounting for the Informal Funding Assets

Reallocation of Assets to Track Participant-Driven Changes in the Liability

	Debit	Credit	Statement Affected
Cash	$225		Balance Sheet
Investment Fund A (Sale)		$225	Balance Sheet
Unrealized Gain in OCI	$8		OCI
Realized Gain		$8	Income
Current Tax Expense	$3		Income
Deferred Tax Component of OCI		$3	OCI
Investment B (Purchase)	$225		Balance Sheet
Cash		$225	Balance Sheet

The sale of mutual fund assets to match the reallocation of participant account balances would result in a reclassification of a proportionate share of unrealized gains from OCI to the P&L, and trigger current tax payable.

First Year of Benefit Payments

	Debit	Credit	Statement Affected
Cash	$115,751		Balance Sheet
Investments		$115,751	Balance Sheet
Investments	$67,818		Balance Sheet
Investment Income		$67,818	Income

To record transfer of funds from investment to cash to pay benefits, and to record investment income for the year. Sample entries related to the payment of benefits are included on Page 5, above, in the Accounting for Plan Liability section.

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Accounting for the Informal Funding Assets

Corporate Owned Life Insurance (COLI)

If the Company elects to informally fund the plan using Corporate-Owned Life Insurance (COLI), the appropriate accounting guidance is ASC 325-30, FTB 85-4 and EITF 06-5.

Year 1 – Purchase of COLI

	Debit	Credit	Statement Affected
Insurance Premium Expense	$50,000		Income
Cash		$50,000	Balance Sheet
Life Insurance Cash Surrender Value	$50,000[4]		Balance Sheet
Insurance Premium Expense		$50,000	Income

[4] A standard COLI contract will have end of year 1 cash value equal to or greater than the premium paid, eliminating any net charge to earnings. Any contractual restrictions on the company's right to surrender the COLI contract should be disclosed.

Year 1 - Growth of Cash Value

	Debit	Credit	Statement Affected
Life Insurance Cash Surrender Value	$2,485		Balance Sheet
Other Income		$2,485	Income
Deferred Tax Expense[5]	-		Income
Deferred Tax Liability[5]		-	Balance Sheet

[5] No deferred tax recognition is required under ASC 740/FAS 109 related to the growth of CSV if it is management's position that the policies will be held for the life of the insured. If management intends to surrender the policies to pay benefits, deferred tax recognition would be required.

First Year of Benefit Payments

	Debit	Credit	Statement Affected
Cash	$71,187[6]		Balance Sheet
Life Insurance Cash Surrender Value		$71,187	Balance Sheet
Life Insurance Cash Surrender Value (Growth)	$44,227		Balance Sheet
Other Income		$44,227	Income

[6] Withdrawals from cash surrender value to pay benefits will generally be non-taxable if properly structured - as withdrawals up to basis and then as policy loans. Sample entries related to the payment of benefits are included on Page 5, above, in the Accounting for Plan Liability section.

In the Event of Death

	Debit	Credit	Statement Affected
Cash (Death Benefit)	$728,953		Balance Sheet
Life Insurance Cash Surrender Value		$582,078	Balance Sheet
Life Insurance Income (Other Income)		$146,875	Income

ABOUT EXECUTIVE BENEFIT SOLUTIONS, LLC

EBS is an independent executive benefits consulting firm which provides total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design,
- The structuring of related financing and benefit security arrangements,
- The design and management of the participant communication, education and enrollment processes,
- Management of any informal funding assets and,
- On-going plan administration and technical support.

More information about the firm can be found at: www.executivebenefitsolutions.com.

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