



Memorandum No. TRS-20040129

Accounting for SERP-PLUS Programs

This memorandum discusses the accounting requirements applicable to an employer that has adopted a Defined Benefit Supplemental Executive Retirement Plan (SERP). A SERP is a non-qualified retirement plan, a promise by a company to pay a future retirement benefit to its executives, separate from any qualified retirement plans that the company may sponsor. That promise is a contractual future obligation and must be disclosed as a liability on the company's financial statements. The company and its auditors must determine the appropriate accounting treatment, based upon the specific facts and circumstances of the arrangement.

Companies also may adopt salary deferral programs, where an executive defers current compensation in exchange for a promise from the company to pay the deferrals, with or without interest, at some future date, typically at retirement. The company may "match" the executive's deferrals, in whole or in part, as an additional enticement to participate in the program. Additionally, earnings growth of the deferred compensation can be related to the performance of outside financial instruments or indices (Treasuries, Moody's AA Bond Fund, etc.), or can be tracked against the performance of one or more mutual funds, or Variable Life Insurance policy separate accounts. Accounting for these programs varies from the requirements for SERPs, and is not discussed in this memorandum.

Whether the nonqualified deferred compensation arrangement is a defined benefit SERP or a defined contribution salary deferral program, the arrangement must be, by its nature, unfunded, to avoid current income taxation to the participants, as well as avoid some of the strictures of ERISA. The funded or unfunded nature of the arrangement has no direct impact on the accounting for the benefit.

Financial Statements

Financial statements, including the company's balance sheet, income statement and cash flow statement, reflect the financial status, operating, and cash flow results of a business operation, generally based upon the application of Generally Accepted Accounting Principles (GAAP). Financial statements reflect a business entity's liquidity, solvency, stability and performance.



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GAAP has been established through a variety of channels, including: prevalent industry practice; Accounting Principles Board (APB) statements and opinions; Financial Accounting Standards Board (FASB) statements, concepts, technical bulletins and interpretations; American Institute of Certified Public Accountants (AICPA) statements, issue papers, bulletins, interpretations and concepts; as well as various other professional announcements, textbooks and articles.

GAAP Reporting vs. IRS Tax Reporting

Income tax reporting differs from financial statement reporting because the objectives for each are different. Income tax accounting, unlike GAAP accounting for financial statements, is based upon the Internal Revenue Code and the Regulations issued by the Internal Revenue Service (IRS) and is designed to generate revenues in support of government operations.

Timing and recognition differences exist between GAAP and tax accounting:

1. Timing differences are based upon the selection of different methods of asset valuation or liability recognition and the determination as to when to reflect any associated income and/or expenses (such as the selection of different methods of depreciation for GAAP and tax return purposes, or the accrual of liabilities associated with expenses in different periods for GAAP and tax return purposes);
2. Recognition differences or "permanent" differences are based upon certain income and expense items being recognized under GAAP but not for tax purposes (such as the inclusion in income for GAAP but not for tax purposes of death proceeds from COLI), or the recognition of income or expenses for tax but not for GAAP purposes.

Financial Accounting Standards Board

The Financial Accounting Standards Board (FASB) is the designated organization in the private sector for establishing standards of financial accounting and reporting. Established in 1973, FASB's standards are officially recognized as authoritative by the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA). FASB publishes a series of Statements of Financial Accounting Standards, Statements of Financial Accounting Concepts, Interpretations and Technical Bulletins. Organizations that follow Generally



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Accepted Accounting Principles (GAAP) use FASB standards in the preparation of financial statements.

A similar organization exists for state and local government entities, the Governmental Accounting Standards Board (GASB). However, this Article will not address government entities, only private sector organizations.

Statement No. 87

Statement of Financial Accounting Standards No. 87, "Employers' Accounting for Pensions" (FAS 87), was published by FASB in December 1985 as the accounting standard for pensions, including qualified and non-qualified plans, both funded and unfunded. FAS 87 superseded Accounting Principles Board Opinion No. 8, "Accounting for the Cost of Pension Plans" (APB 8), issued in 1966. FAS 87:

"...applies to any arrangement that is similar in substance to a pension plan regardless of the form or means of financing. This Statement applies to a written plan and to a plan whose existence may be implied from a well-defined, although perhaps unwritten, practice of paying postretirement benefits." (FAS 87, para. 7)

FAS 87 does not supersede Accounting Principles Board Opinion No. 12, (APB 12) which addresses accounting for the cost of deferred compensation contracts with individual employees, that when taken together, are not equivalent to a pension plan. Thus, APB 12 continues to apply to individual deferred compensation arrangements. To the extent that an employer has created a plan that encompasses two or more otherwise individual deferred compensation agreements, the plan is specifically subject to the requirements of FAS 87, and not APB 12.

Virtually all SERPs are subject to FAS 87. The provisions of FAS 87 do not, however, apply to immaterial items.

FAS 87 requires that the present value of the future retirement benefit payments be recognized as a liability in the financial statements of the employer. The benefit's present value is amortized over the remaining working period of employment, so that when the employee retires, the present value of the benefit stream has been fully accrued.



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Reasonable assumptions must be made with regards to computing the liabilities. For example, if the retirement benefit is based on salary at retirement, a reasonable assumption with regards to growth in salary (salary scale) must be used. Similarly, if the benefit is based on a unit credit formula (e.g., 2.0% per year of service), credit for service through normal retirement age must be applied.

Selection of the interest discount rate used to compute the present value liability is obviously important to the process. FAS 87 does not identify a specific rate to use, nor does it provide a specific source of identifying the discount rate. Rather FAS 87 states:

"...Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement ... employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits...." (FAS 87, par. 44)

While qualified pension plans are funded plans with plan assets, non-qualified plans (SERPs) are unfunded plans, having no direct or formal plan assets. The method of computing the benefit liability is identical for funded and unfunded plans, however, and the discount rate selected is independent of the expected returns of any plan assets. As an aside, non-qualified plans may be informally funded or financed, frequently with Company Owned Life Insurance (COLI).

The sponsoring company and its auditors, often with the advice of a consulting actuary, select the discount rate to be used (as well as other actuarial assumptions).

Accounting in Accordance with FAS 87

Liabilities under FAS 87 are established under three categories: past service liability, future service liability, and interest.

The past service liability is computed as if the SERP had been created coincident with employment commencement for each plan participant. The amount of the past service liability is the amount that would have been accrued to date if accrual had started at the time that employment started. An equivalent amount is recognized as an



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Intangible Asset. The Intangible Asset is amortized evenly over the employee's working life (from now through normal retirement age), or fifteen years, whichever is greater. This is referred to as the Projected Benefit Obligation (PBO) Level Amortization.

The future service liability, or Current Service Obligation (CSO) is based on the ratio of future service to past service. It represents the present value of the remaining retirement liability (in excess of the PBO), amortized over the employee's future working life.

The interest accrual recognizes the interest component of the past service liability and the future service liability.

Statement No. 132

In February 1998 FASB issued Statement of Financial Accounting Standards No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" FAS 132. That Statement set forth financial statement disclosure requirements with respect to pension and other postretirement benefits. The Statement is limited to disclosure and is not intended to prescribe measurement or recognition guidelines.

The Statement requires employers that sponsor one or more defined benefit pension or postretirement plans to provide information, including:

1. A reconciliation of the benefit obligation and plan assets, and funded status of the plan
2. Employer contributions, participant contributions and benefits paid
3. Amounts recognized in the statement of financial position, including assets and liabilities, and any income recognized under Statement 87
4. The net periodic benefit cost recognized
5. The assumed discount rate, rate of compensation increase and return on plan assets expected

These amounts must be disclosed for each balance sheet and income statement presented. Aggregation of amounts for more than one plan is permitted in certain circumstances. Also, nonpublic entities are permitted to present somewhat abbreviated disclosures with respect to their plans.



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Statement No. 109

Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes," (FAS 109) was published by FASB in February 1992 as the accounting standard for reflecting income taxes that result from a company's activities during the current and preceding years. FAS 109 superseded FAS 96, "Accounting for Income Taxes," as well as a number of other accounting pronouncements.

Under FAS 109, a deferred tax asset (or liability) is recognized for the estimated future tax effects attributable to temporary differences and carryforwards. Further, the measurement of current and deferred tax assets (and liabilities) is based on provisions of the enacted tax law; the effects of possible future changes in tax laws or rates are not anticipated. Finally, the measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

FAS 109 establishes the principle that, if a company accrues a SERP liability and expects that such accrual will result in a tax deduction at some future date, the company can reduce its tax expense and record a deferred tax asset today in anticipation of that future deduction.

COLI Accounting Treatment

COLI is accounted for independently of the SERP in accordance with FASB's "Cash Surrender Value" method of accounting, pursuant to FASB Technical Bulletin 85-4 (FAS TB 85-4), "Accounting for Purchases of Life Insurance," published on November 14, 1985. This methodology reflects in net income the net difference between (1) each year's premium payment, (2) cash surrender value change and (3) death proceeds received, as an aggregate charge or credit to earnings. However, for tax purposes premium payments generally are not deductible, while both cash surrender value changes and death proceeds received are not taxable.

Summary

Accounting for SERP arrangements is a complex area. This memorandum provides an overview of the accounting issues and applicability of various FASB accounting pronouncements to SERP-PLUS Programs. This memorandum is for informational purposes only and is not intended as legal, accounting or tax advice. Clients should consult with their own professional advisors as to how this material may apply to their own specific circumstances.



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About Retirement Capital Group ("RCG")

RCG provides supplemental executive benefit programs to a wide range of commercial clients. We focus on developing cost effective executive benefit solutions that are designed to attract, reward and retain key employees.

Our services are designed to assist clients at all stages in the adoption and operation of executive benefit programs and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

RCG's professional staff includes the following professional disciplines, all dedicated to supporting our client's programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and cost effective and that they are designed to achieve our clients' strategic and operational goals.

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