



Office of Thrift Supervision
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RESCINDED

This rescission applies to the transmitting document only and not the attached interagency guidance. Refer to (OCC 2004-10) for the status of the attached interagency guidance.

February 11, 2004

MEMORANDUM FOR: CHIEF EXECUTIVE OFFICERS
FROM: Scott M. Albinson *Scott M. Albinson*
SUBJECT: Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance

On February 11, 2004, the Office of Thrift Supervision, along with the other federal banking agencies, issued an advisory on accounting for deferred compensation agreements and bank-owned life insurance (BOLI). The banking agencies have identified many institutions that have incorrectly accounted for obligations under a type of deferred compensation agreement commonly referred to as a revenue neutral plan or an indexed retirement benefit plan.

Institutions should review their accounting for such agreements to ensure that obligations under the agreements have been appropriately measured and reported.

A copy of the advisory is attached to this memorandum. Questions regarding this advisory should be directed to your regional OTS office or Patricia M. Hildebrand, Accountant, (202) 906-7048.

Enclosure: Advisory

**INTERAGENCY ADVISORY ON ACCOUNTING FOR DEFERRED
COMPENSATION AGREEMENTS AND BANK-OWNED LIFE INSURANCE**

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are issuing this advisory to provide guidance on the appropriate accounting treatment for deferred compensation agreements that banks and thrift institutions (institutions) enter into with employees. Through the examination process, the agencies have identified many institutions that have incorrectly accounted for obligations under a type of deferred compensation agreement commonly referred to as a revenue neutral plan or an indexed retirement plan (collectively referred to as IRPs). Institutions should review their accounting for deferred compensation agreements to ensure that obligations under the agreements have been appropriately measured and reported.

Institutions often purchase life insurance in conjunction with establishing deferred compensation programs. Therefore, this advisory also addresses the appropriate accounting treatment for bank-owned life insurance (BOLI).

The agencies believe the guidance in this issuance is consistent with generally accepted accounting principles (GAAP) as specified in Accounting Principles Board Opinion No. 12, *Omnibus Opinion—1967*, as amended by Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (SFAS 106) [hereafter referred to as APB 12], and FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance* (FTB 85-4). Institutions are expected to apply the guidance in this issuance when preparing Reports of Condition and Income (Call Reports) and Thrift Financial Reports (TFRs).

Background

Institutions often enter into deferred compensation agreements with selected employees as part of executive compensation and retention programs. These agreements are generally structured as nonqualified retirement plans for federal income tax purposes and are based upon individual agreements with selected employees. Institutions purchase BOLI in connection with many of these agreements. BOLI may produce attractive tax-equivalent yields that offset some or all of the costs of the agreements.

IRPs are one type of deferred compensation agreement that institutions enter into with selected employees. IRPs are typically designed so that the spread each year, if any, between the tax-equivalent earnings on the BOLI covering an individual employee and a hypothetical earnings calculation is deferred and paid to the employee as a postretirement benefit. This spread is commonly referred to as “excess earnings.” The hypothetical earnings are computed based on a pre-defined variable index rate (e.g., cost of funds or federal funds rate) times a notional amount. The notional amount is typically the amount the institution initially invested to purchase the BOLI plus subsequent after-tax benefit payments actually made to the employee. By including the after-tax benefit payments and the amount initially invested to purchase the BOLI in the notional amount, the hypothetical earnings reflect an estimate of what the institution could have earned if it had not invested in the BOLI or entered into the IRP with the employee. Each employee’s IRP may have a different notional amount upon which the index is based. The individual IRP agreements also specify the retirement age and vesting provisions, which can vary from employee to employee.

An IRP agreement typically requires the excess earnings that accrue before an employee’s retirement to be recorded in a separate liability account. Once the employee retires, the balance in the liability account is generally paid to the employee in equal, annual installments over a set number of years (e.g., 10 or 15 years). These payments are commonly referred to as the “primary benefit” or “preretirement benefit.”

The employee may also receive the excess earnings that are earned after retirement. This benefit may continue until his or her death and is commonly referred to as the “secondary benefit” or “postretirement benefit.” The secondary benefit is paid annually, once the employee has retired, in addition to the primary benefit.

Accounting for Deferred Compensation Agreements Including IRPs

Deferred compensation agreements with select employees under individual contracts generally do not constitute postretirement income plans (i.e., pension plans) or postretirement health and welfare benefit plans. The accounting for individual contracts that, when taken together, do not represent a postretirement plan should follow APB 12. If the individual contracts, taken together, are equivalent to a plan, the plan should be accounted for under Statement of Financial Accounting Standards No. 87, *Employers’ Accounting for Pensions*, or SFAS 106.

APB 12 requires that an employer’s obligation under a deferred compensation agreement be accrued according to the terms of the individual contract over the required service period to the date the employee is fully eligible to receive the benefits, i.e., the “full eligibility date.” Depending on the individual contract, the full eligibility date may be the employee’s expected retirement date, the date the employee entered into the contract, or a date between these two dates. APB 12 does not prescribe a specific accrual method for the benefits under deferred compensation contracts, stating only that the “cost of those benefits shall be accrued over that period of the employee’s service in a systematic and rational manner.” The amounts to be accrued each period should result in a deferred

compensation liability at the full eligibility date that equals the then present value of the estimated benefit payments to be made under the individual contract.

APB 12 does not specify how to select the discount rate to measure the present value of the estimated benefit payments. Therefore, other relevant accounting literature must be considered in determining an appropriate discount rate. The agencies view an institution's incremental borrowing rate¹ and the current rate of return on high-quality fixed-income debt securities² to be acceptable discount rates to measure deferred compensation agreement obligations. An institution must select and consistently apply a discount rate policy that conforms with GAAP.

For each IRP, an institution should calculate the present value of the expected future benefit payments under the IRP at the employee's full eligibility date. The expected future benefit payments can be reasonably estimated, should be based on reasonable and supportable assumptions, and should include both the primary benefit and, if the employee is entitled to excess earnings that are earned after retirement, the secondary benefit. The estimated amount of these benefit payments should be discounted because the benefits will be paid in periodic installments after the employee retires. The number of periods the primary and any secondary benefit payments should be discounted may differ because the discount period for each type of benefit payment should be based upon the length of time during which each type of benefit will be paid as specified in the IRP.

After the present value of the expected future benefit payments has been determined, the institution should accrue an amount of compensation expense and a liability each year from the date the employee enters into the IRP until the full eligibility date. The amount of these annual accruals should be sufficient to ensure that a deferred compensation liability equal to the present value of the expected benefit payments is recorded by the full eligibility date. *Any method of deferred compensation accounting that does not recognize some expense for the primary benefit and any secondary benefit in each year from the date the employee enters into the IRP until the full eligibility date is not systematic and rational.*

Vesting provisions should be reviewed to ensure that the full eligibility date is properly determined because this date is critical to the measurement of the liability estimate. Because APB 12 requires that the present value of the expected benefit payments be recorded by the full eligibility date, institutions also need to consider changes in market interest rates to appropriately measure deferred compensation liabilities. Therefore, to comply with APB 12, the agencies believe institutions should periodically review their estimates of the expected future benefits under IRPs and the discount rates used to

¹ Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*, paragraph 13, states in part that "the rate used for valuation purposes will normally be at least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction."

² SFAS 106, paragraph 186, states that "[t]he objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due."

compute the present value of the expected benefit payments and revise the estimates and rates, when appropriate.

Deferred compensation agreements, including IRPs, may include noncompete provisions or provisions requiring employees to perform consulting services during postretirement years. If the value of the noncompete provisions cannot be reasonably and reliably estimated, no value should be assigned to the noncompete provisions in recognizing the deferred compensation liability. Institutions should allocate a portion of the future benefit payments to consulting services to be performed in postretirement years only if the consulting services are determined to be substantive. Factors the agencies would consider in determining whether postretirement consulting services are substantive include, but are not limited to, whether the services are required to be performed, whether there is an economic benefit to the institution, and whether the employee forfeits the benefits under the agreement for failure to perform such services.

Refer to the appendix for examples of the full eligibility date accounting requirements for a basic deferred compensation agreement.

Accounting for Bank-Owned Life Insurance

FTB 85-4 addresses the accounting for BOLI. Only the amount that could be realized under the insurance contract as of the balance sheet date (i.e., the cash surrender value reported to the institution by the insurance carrier less any applicable surrender charges not reflected by the insurance carrier in the reported cash surrender value) is reported as an asset. *Because there is no right of offset, an investment in BOLI should be reported as an asset separately from the deferred compensation liability.*

Changes in Accounting for Deferred Compensation Agreements

Institutions should follow Accounting Principles Board Opinion No. 20, *Accounting Changes* (APB 20), if a change in their accounting for deferred compensation agreements, including IRPs, is necessary. APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states that “[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared.”

The agencies have observed that accounting errors under APB 20 that relate to IRPs often result from one or a combination of the following items:

- (1) The failure to accrue a liability for the estimated cost of benefit payments related to the excess earnings from the primary benefit and any secondary benefit that the employee will be entitled to receive after retirement.
- (2) The failure to accrue the present value of the expected future benefit payments by the full eligibility date.

- (3) The failure to appropriately consider the impact of vesting provisions on the full eligibility date.

For Call Report and TFR purposes, an institution must determine whether the reason for a change in its accounting for deferred compensation agreements meets the APB 20 definition of an accounting error. If the reason for the change meets this definition, the error should be reported as a prior period adjustment in the Call Report or TFR if the amount is material. Otherwise, the effect of the correction of the error should be reported in current earnings. If the effect of the correction of the error is material, the institution should also consult with its primary federal regulatory agency to determine whether any of its prior Call Reports or TFRs should be amended.

If amended Call Reports or TFRs are not required, the institution should report the effect of the correction of the error on prior years' earnings, net of applicable taxes, as an adjustment to the previously reported beginning balance of equity capital. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, Item 2, "Restatements due to corrections of material accounting errors and changes in accounting principles," with an explanation in Schedule RI-E, Item 4. For the TFR, the institution should report the amount in Schedule SI, Line SI668, "Prior period adjustments."

The effect of the correction of the error on income and expenses since the beginning of the year in which the error is corrected should be reflected in each affected income and expense account on a year-to-date basis in the next quarterly Report of Income or Consolidated Statement of Operations to be filed and not as a direct adjustment to retained earnings.

Reporting of BOLI and Deferred Compensation Agreements in Call Reports and TFRs

The table below sets forth the appropriate reporting of BOLI in Call Reports and TFRs.

Call Report Item	TFR Line³	Amount to Report
Schedule RC, Item 11, "Other assets," and Schedule RC-F, Item 5, "All other assets"	SC625, "Bank-Owned Life Insurance: Other"	Include the amount that could be realized under BOLI policies as of the report date.
Schedule RC-F, Item 5.b, "Cash surrender value of life insurance"	Not applicable	For the Call Report, include the amount that could be realized under BOLI policies as of the report date if such amount is greater than \$25,000 and exceeds 25% of the total of "All other assets" reported in Schedule RC-F, Item 5.

³ The TFR lines reflect changes to the TFR form for 2004. For reporting periods prior to March 2004, consult the TFR instructions for the applicable period.

Call Report Item	TFR Line	Amount to Report
Schedule RI, Item 5.l, “Other noninterest income”	SO488, “Other Noninterest Income”	Include the net change in the cash surrender value of BOLI policies. ⁴
Schedule RI-E, Item 1.b, “Earnings on/increase in value of cash surrender value of life insurance”	SO492, 496, or 498, “Detail of Other Noninterest Income”	For the Call Report, include the net change in the cash surrender value of BOLI policies if such amount is greater than 1% of the sum of total interest income and total noninterest income. For the TFR, include on SO492, 496, or 498 if the amount is one of the two largest items comprising the amount reported in SO488.
Schedule RI, Item 7.d, “Other noninterest expense”	Not applicable	For the Call Report, include the BOLI expenses for policies in which the institution is the beneficiary. ⁵
Schedule RI-E, Item 2.h, “Other noninterest expense”	Not applicable	For the Call Report, include the BOLI expenses for policies in which the institution is the beneficiary if such amount is greater than 1% of the sum of total interest income and total noninterest income.

The following table sets forth the appropriate reporting of deferred compensation agreements in Call Reports and TFRs.

Call Report Item	TFR Line	Amount to Report
Schedule RC, Item 20, “Other liabilities,” and Schedule RC-G, Item 4, “All other liabilities”	SC796, “Other liabilities and deferred income”	Include the amount of deferred compensation liabilities.
Schedule RC-G, Item 4.b, “Deferred compensation liabilities”	SC792, 795, or 798, “Detail of other liabilities”	For the Call Report, include the amount of deferred compensation liabilities if such amount is greater than \$25,000 and exceeds 25% of the total of “All other liabilities” reported in Schedule RC-G, Item 4. For the TFR, report on SC792, 795, or 798 if the amount is one of the three largest items constituting the amount reported in SC796.
Schedule RI, Item 7.a, “Salaries and employee benefits”	SO510, “All personnel compensation and expense”	Include the annual compensation expense (service component and interest component) related to deferred compensation agreements.

⁴ The net change in the cash surrender value (i.e., gross earnings (losses) on or increases (decreases) in value less BOLI policy expenses) is reported for TFR purposes. For Call Reports, the net earnings (losses) on or the net increases (decreases) in the cash surrender value may be reported. Alternatively, the gross earnings (losses) on or increases (decreases) in value may be reported in Schedule RI, Item 5.l, and the BOLI policy expenses may be reported in Schedule RI, Item 7.d.

⁵ Applicable for Call Reports only if institutions report the gross earnings (losses) on or increases (decreases) in the cash surrender value in Call Report Schedule RI, Item 5.l.

Additional Information

For further information on the appropriate accounting for deferred compensation agreements, please contact Brent M. Kukla, OCC Accounting Fellow, at (202) 874-4978; Rusty Thompson, OCC District Accountant, at (214) 720-7078; Christine M. Bouvier, FDIC Senior Policy Analyst (Bank Accounting), at (202) 898-7289; Arthur Lindo, FRB Project Manager, at (202) 452-2695; or Patricia M. Hildebrand, OTS Accountant, at (202) 906-7048.

Appendix

Examples of Accounting for Deferred Compensation Agreements

The agencies have developed the following examples to provide general guidance on full eligibility date accounting requirements for a basic deferred compensation agreement. The assumptions used in these examples are for illustrative purposes only. An institution must consider the terms of its specific agreements, the current interest rate environment, and current mortality tables in determining appropriate assumptions to use in measuring and recognizing the present value of the benefits payable under its deferred compensation agreements.

Institutions that enter into deferred compensation agreements with employees, particularly more complex agreements, such as IRPs, should consult with their external auditors and their primary federal regulatory agency concerning the appropriate accounting for their specific agreements.

Example 1: Fully Eligible at Agreement Inception

A company enters into a deferred compensation agreement with a 55-year-old employee who has worked five years for the company. The agreement states that in exchange for past and future services and for the employee serving as a consultant for two years after he or she retires, the company will pay an annual benefit of \$20,000 to the employee, commencing on the first anniversary of the employee's retirement. The employee is fully eligible for the deferred compensation benefit payments at the inception of the agreement, and the consulting services are not substantive.

Other key facts and assumptions used in determining the benefits payable under the agreement and the liability and expense to be recorded by the company in each period are summarized in the following table:

Expected retirement age	60
Number of years to expected retirement age	5
Discount rate (%)	6.75
Expected mortality age based on present age	70

At the employee's expected retirement date, the present value of a lifetime annuity of \$20,000 that begins on that date is \$142,109 (computed as \$20,000 times 7.10545, the factor for the present value of 10 annual payments at 6.75 percent). At the inception date of the agreement, the present value of that annuity of \$102,514 (computed as \$142,109 times 0.721375, the factor for the present value of a single payment in five years at 6.75 percent) is recognized as compensation expense, because the employee is fully eligible for the deferred compensation benefit at that date.

The following table summarizes *one* systematic and rational method of recognizing the expense and liability under the deferred compensation agreement:

	A	B	C	D (B+C)	E	F (E+D-A)
Year	Benefit Payment (\$)	Service Component (\$)	Interest Component (\$)	Compensation Expense (\$)	Beginning of Year Liability (\$)	End of Year Liability (\$)
0	-	102,514	-	102,514	-	102,514
1	-	-	6,920	6,920	102,514	109,434
2	-	-	7,387	7,387	109,434	116,821
3	-	-	7,885	7,885	116,821	124,706
4	-	-	8,418	8,418	124,706	133,124
5	-	-	8,985	8,985	133,124	142,109
6	20,000	-	9,593	9,593	142,109	131,702
7	20,000	-	8,890	8,890	131,702	120,592
8	20,000	-	8,140	8,140	120,592	108,732
9	20,000	-	7,339	7,339	108,732	96,071
10	20,000	-	6,485	6,485	96,071	82,556
11	20,000	-	5,572	5,572	82,556	68,128
12	20,000	-	4,599	4,599	68,128	52,727
13	20,000	-	3,559	3,559	52,727	36,286
14	20,000	-	2,449	2,449	36,286	18,735
15	20,000	-	1,265	1,265	18,735	-
Totals	200,000	102,514	97,486	200,000		

The following entry would be made at the inception date of the agreement (the final day of “Year 0”) to record the service component of the compensation expense and related deferred compensation agreement liability:

	<u>Debit</u>	<u>Credit</u>
Compensation Expense	\$102,514	
Deferred Compensation Liability		\$102,514
		[To record the column “B” service component]

In each period after the inception date of the agreement, the company would adjust the deferred compensation liability for the interest component and any benefit payment. In addition, the company would reassess the assumptions used in determining the expected future benefits under the agreement and the discount rate used to compute the present value of the expected benefits in each period after the inception of the agreement and revise the assumptions and rate, as appropriate.

Assuming no changes were necessary to the assumptions used to determine the expected future benefits under the agreement or the discount rate used to compute the present value of the expected benefits, the following entry would be made in “Year 1” to record the interest component of the compensation expense:

	<u>Debit</u>	<u>Credit</u>
Compensation Expense	\$6,920	
Deferred Compensation Liability		\$6,920
	[To record the column "C" interest component (computed by multiplying the prior year column "F" balance by the discount rate)]	

Similar entries (but for different amounts) would be made in "Year 2" through "Year 15" to record the interest component of the compensation expense.

The following entry would be made in "Year 6" to record the payment of the annual benefit:

	<u>Debit</u>	<u>Credit</u>
Deferred Compensation Liability	\$20,000	
Cash		\$20,000
	[To record the column "A" benefit payment]	

Similar entries would be made in "Year 7" through "Year 15" to record the payment of the annual benefit.

Example 2: Fully Eligible at Retirement Date

If the terms of the contract described in Example 1 had stated that the employee is entitled to receive the deferred compensation benefit only if the sum of the employee's age and years of service equal 70 or more at the date of retirement, the employee would be fully eligible for the deferred compensation benefit at age 60, after rendering five more years of service. At the employee's expected retirement date, the present value of a lifetime annuity of \$20,000 that begins on the first anniversary of that date is \$142,109 (computed as \$20,000 times 7.10545, the factor for the present value of 10 annual payments at 6.75 percent). The company would accrue this amount in a systematic and rational manner over the five-year period from the date the agreement is entered into, to the date the employee is fully eligible for the deferred compensation benefit. Under *one* systematic and rational method, the annual service component accrual would be \$24,835 (computed as \$142,109 divided by 5.72213, the factor for the future value of five annual payments at 6.75 percent).

Other key facts and assumptions used in determining the benefits payable under the agreement and the liability and expense to be recorded each period by the company are summarized in the following table:

Expected retirement age	60
Number of years to expected retirement age	5
Discount rate (%)	6.75
Expected mortality age based on present age	70

The following table summarizes *one* systematic and rational method of recognizing the expense and liability under the deferred compensation agreement:

	A	B	C	D (B+C)	E	F (E+D-A)
Year	Benefit Payment (\$)	Service Component (\$)	Interest Component (\$)	Compensation Expense (\$)	Beginning of Year Liability (\$)	End of Year Liability (\$)
1	-	24,835	-	24,835	-	24,835
2	-	24,835	1,676	26,511	24,835	51,346
3	-	24,835	3,466	28,301	51,346	79,647
4	-	24,835	5,376	30,211	79,647	109,858
5	-	24,835	7,416	32,251	109,858	142,109
6	20,000	-	9,593	9,593	142,109	131,702
7	20,000	-	8,890	8,890	131,702	120,592
8	20,000	-	8,140	8,140	120,592	108,732
9	20,000	-	7,339	7,339	108,732	96,071
10	20,000	-	6,485	6,485	96,071	82,556
11	20,000	-	5,572	5,572	82,556	68,128
12	20,000	-	4,599	4,599	68,128	52,727
13	20,000	-	3,559	3,559	52,727	36,286
14	20,000	-	2,449	2,449	36,286	18,735
15	20,000	-	1,265	1,265	18,735	-
Totals	200,000	124,175	75,825	200,000		

No entry would be made at the inception date of the agreement. The following entry would be made in “Year 1” to record the service component of the compensation expense and related deferred compensation agreement liability:

	Debit	Credit
Compensation Expense	\$24,835	
Deferred Compensation Liability		\$24,835
		[To record the column “B” service component]

Similar entries would be made in “Year 2” through “Year 5” to record the service component of the compensation expense.

In each subsequent period, until the date the employee is fully eligible for the deferred compensation benefit, the company would adjust the deferred compensation liability for the total expense (i.e., service and interest components). In each period after the full eligibility date, the company would adjust the deferred compensation liability for the interest component and any benefit payment. In addition, the company would reassess the assumptions used in determining the expected future benefits under the agreement and the discount rate used to compute the present value of the expected benefits in each

period after the inception of the agreement and revise the assumptions and rate, as appropriate.

Assuming no changes were necessary to the assumptions used to determine the expected future benefits under the agreement or the discount rate used to compute the present value of the expected benefits, the following entry would be made in “Year 2” to record the interest component of the compensation expense:

	<u>Debit</u>	<u>Credit</u>
Compensation Expense	\$1,676	
Deferred Compensation Liability		\$1,676
	[To record the column “C” interest component (computed by multiplying the prior year column “F” balance by the discount rate)]	

Similar entries (but for different amounts) would be made in “Year 3” through “Year 15” to record the interest component of the compensation expense.

The following entry would be made in “Year 6” to record the payment of the annual benefit:

	<u>Debit</u>	<u>Credit</u>
Deferred Compensation Liability	\$20,000	
Cash		\$20,000
	[To record the column “A” benefit payment]	

Similar entries would be made in “Year 7” through “Year 15” to record the payment of the annual benefit.