Recent Federal Bank Regulatory Accounting Advisory
Merits Review of Nonqualified Deferred Compensation

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Until recently, accounting guidance issued by the federal banking regulators did not make it crystal clear a deferred compensation plan that afforded a participant the opportunity to retire early and collect the full promised benefit required that the promised benefit be fully accrued by the time of eligibility for such vested benefit. On February 11, 2004, the banking agencies issued an "Interagency Advisory on Accounting for Deferred Compensation Agreements and BOLI" (the "Advisory"). Citing extensively to Accounting Principles Board Opinion No. 12, the Advisory states that banks should review their accounting for all types of deferred compensation agreements to ensure that obligations under the agreements have been properly measured and reported in accordance with GAAP. According to the Advisory, APB 12 requires that the employer's obligation under a deferred compensation agreement be accrued over the required service period to the date the employee is fully eligible to receive benefits —

> *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. . . .* The amounts to be accrued each period should result in a deferred compensation liability that, as the date the employee becomes eligible to receive benefits, equals the then present value of the estimated benefit payments to be made under the individual contract. . . *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.* (emphasis added in italics)

The Advisory further states that any necessary changes that must be made to a bank's accounting for deferred compensation agreements should be reflected in the banks March 31, 2004 call report.

According to the Advisory, an acceptable discount rate to measure the present value of the estimated benefit payments would use the current rate of return on high quality fixed-income debt securities. The nation's largest administrator and servicer of BOLL-financed deferred compensation obligations uses the yield on the 20 year AA corporate bond to determine the discount rate for deferred compensation defined benefit plans. Because many banks have existing deferred compensation agreements that were established in a higher interest rate environment, banks should review the appropriateness of the discount rate used to accrue benefits. There are good reasons to select an accrual rate at the lower end of the range that is considered reasonable. While a bank and its external auditors might believe a certain discount rate is appropriate under GAAP, the bank would be wise not to discount the possibility that bank examiners, the SEC, a sophisticated investor, or a possible acquirer might view the bank's SERP discount rate as too high such that an argument could be fashioned to the effect that the Bank is under accruing for its SERP liabilities. Witness the last year's hubbub accorded some companies' unrealistic assumptions regarding pension plan returns that led to revised downward return assumptions many companies were forced to make in light of critical investor and business trade press review of the matter. Just because an external auditor concurs with a company's accounting judgment on a particular issue does not mean that the company's presentation will withstand scrutiny from other interested quarters.

The very fact that bank regulators have felt compelled to issue such detailed statements of what the banking agencies view to be appropriate GAAP accounting treatment for deferred compensation obligations and the breadth of guidance enunciated in the February 11, 2004 Advisory probably means that many banks have not accounted appropriately for deferred compensation obligations. Many banks with deferred compensation obligations, even if those deferred compensation obligations do not relate to so-called indexed retirement or revenue neutral SERPs, will find the accounting guidance set forth in the February 11, 2004 Advisory to be an abrupt change compared to past practices. It is for this reason that we are alerting you to the substance of the February 11, 2004 Advisory.

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