FDIC
Federal Deposit Insurance Corporation

April 16, 2001

Board of Directors

Member of the Board:

Subject: **Life Insurance and Indexed Retirement Agreements (Deferred Compensation Contract)**

During the recent examination of your institution, the life insurance policy and Indexed Retirement Agreement (Agreement) on were reviewed. Currently, the bank has only accrued a liability for actual excess earnings on the life insurance policy to date. After further review, we believe that the current accounting for these items is incorrect according to generally accepted accounting principles (GAAP). The bank's obligations under the deferred compensation contract are separate and distinct from the purchase of life insurance, and such should be accounted for according to GAAP.

According to Financial Accounting Standards Board (FASB) Technical Bulletin Number 85-4, Accounting for Purchases of Life Insurance, the cash surrender value method is the only generally accepted accounting method for purchases of life insurance. The amount that can be realized under the insurance contract as of the date of the statement of financial position should be reported as an asset.

The bank entered into a separate agreement with whereby his salary will continue after retirement based on certain conditions. GAAP requires accounting for deferred compensation agreements by one of the following methods:

1) a deferred compensation contract under Accounting Principles Board (APB) Opinion No. 12, as amended by Statement of Financial Accounting Standards (SFAS) 106, paragraph 13;
2) a defined contribution pension plan under SFAS 87;
3) a defined benefit pension plan under SFAS 87; or
4) other postretirement benefits under SFAS 106.

The circumstances and terms of the agreement determine the proper accounting method that should be used to account for the agreement.

The Agreement does not appear to meet the definition of a defined contribution pension plan nor a defined benefit pension plan under SFAS 87. The basic elements of pension accounting include segregating and restricting (usually in a trust) the plan assets – usually stock, bonds, and other investments – to provide for pension benefits. Paragraph 19 of SFAS 87, states, in part, that "assets not segregated in a trust or otherwise effectively restricted so that they cannot be used by the employer for other purposes are not plan assets for purposes of this Statement even though it may be intended that such assets be used to provide pensions." Since the insurance policy has not been segregated and restricted for the payment of postretirement benefits, it does not constitute "plan assets" and, therefore SFAS 87 does not apply.

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SFAS 106 provides guidance for accounting for postretirement benefits other than pensions. "An employers practice of providing postretirement benefits to selected employees under individual contracts, with specific terms Determined on an individual-by-individual basis, does not constitute a postretirement benefit plan under this Statement." Since the bank only offered the deferred compensation contract to one individual, it does not constitute a post retirement income plan or a postretirement health or welfare benefit plan under SFAS 106.

Paragraph 13 of SFAS 106 states the following:

> "FASB Statement No. 87, Employers Accounting for Pensions, or Statement No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions, applies to deferred compensation contracts with individual employees if those contracts, taken together, are equivalent to a postretirement income plan or a postretirement health or welfare benefit plan, respectively. Other deferred compensation contracts shall be accepted for individually on an accrual basis in accordance with the terms of the underlying contract."

FAS 106, paragraph 13 further states:

> "To the extent the terms of the contract attribute all or a portion of the expected future benefits to a period of service greater than one year, the cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner. At the end of that period the aggregate amount accrued shall equal the then present value of the benefits expected to be provided to the employee, any beneficiaries, and covered dependents in exchange for the employee's service to that date."

The Agreement between the bank and should be treated as a deferred compensation contract according to APB Opinion No. 12, as amended by SFAS 106, paragraph 13. APB No. 12 was amended to explicitly require that an employer's obligation under deferred compensation contracts be accrued following the terms of the individual contract over the required service period to the date the employee is fully eligible for the benefits.

SFAS 106, paragraph 13, refers to the expected future benefits. The fact that the Agreement does not guarantee any payments to does not mean that SFAS 106 is not applicable. Even though the Agreement is basing the retirement payments on the excess earnings of the life insurance policies each year, the insurance policy does not serve as the funding vehicle for the deferred salary payments. Since the bank does not receive any funds from the life insurance policy until the death of the employee at which time the death proceeds are disbursed, the bank is actually funding the postretirement benefits.

A letter from McGladrey & Pullen, LLP discusses the proposed Indexed Retirement Plan and states that "the liability for the present value of the estimated payments to be made under the Agreement should be accrued during the period of active service using a rational and systematic method." The letter further states that the bank should "determine a principal amount to accrue in each accounting period which, when compound interest is added, will accumulate to an amount at the retirement date equal to the then present value of the future estimated payments to be made." McGladrey & Pullen also state that "regardless of the method of accrual, the estimate of the total payments to be made should be adjusted annually, through a change in accounting estimate, during the period of active service for differences between the estimated returns on the simulated investment and the actual returns to date and the related differences between the estimated and actual opportunity cost of funds." This information appears to be in conformance with GAAP; however, the bank did not follow this guidance.

The examiners have indicated that the bank has expressed concern over accruing this liability. Since or his beneficiaries are only entitled to the amount of the deferred account as defined in the Agreement, the bank may choose to set up a separate account reflecting this amount. However, having a separate account does not relieve the bank of its obligation to accrue for all expected future benefits that the bank will distribute to .

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In summary, in accordance with FASB Technical Bulletin Number 85-4 and APB No. 12 under GAAP, the bank should do the following:

a) record the cash surrender value as an "Other Asset" for its interest in the life insurance policy
b) determine the present value of the expected future benefits of the Agreement
c) accrue in a systematic and rational manner for (b) during Mr. Doyle's active service so that at his full eligibility date, the present value of all future benefits has been accrued.

We trust that we have adequately explained our position regarding the accounting treatment of the transactions and their relation to GAAP. Should you have further questions, please do not hesitate to contact Case Manager or Regional Accounting Specialist .

Sincerely,

Regional Director

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