

## New Accounting Standard Provides Greater Flexibility for Informally Funded Nonqualified Plans

By Peter P. Bell, William J. Bowden, and Richard Faw

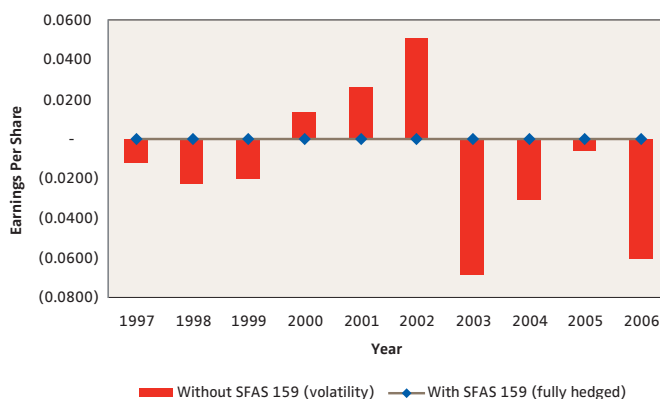
**A** new accounting standard, FAS 159 *The Fair Value Option for Financial Assets and Financial Liabilities*, provides an intriguing opportunity to sponsors wishing to informally fund<sup>1</sup> their nonqualified retirement programs. For fiscal years beginning after November 15, 2007, companies have the option to account for certain financial instruments at fair value and report in earnings the unrealized gains and losses on securities for which the company has elected the fair value option.

A FAS 159 election may be of particular interest to sponsors of nonqualified deferred compensation plans and supplemental executive retirement plans. The election may be especially useful for nonqualified plans that are defined contribution plans where participants allocate their deferrals and account balances among a menu of notional funds.

While a FAS 159 election cannot be applied to assets held in trust for pension and other postretirement benefits, it can be applied to assets informally held by the company (or in a rabbi trust) for nonqualified plans. Thus, by making a FAS 159 election, sponsors can hedge their income statement exposure to certain kinds of benefit cost volatility.

How, specifically, does FAS 159 change things? Figure 1 provides a simplified comparison of accounting for a funding strategy with and without a FAS 159 election.

**Figure 1 |** A funding strategy with and without a FAS 159 election<sup>2</sup>



<sup>1</sup> The term “informally fund” is used because the favorable tax treatment to plan participants applicable to nonqualified benefit plans depends on any funding being limited to corporate assets which remain available to creditors in the event of insolvency.

<sup>2</sup> Graph is designed solely to illustrate the impact of a FAS 159 election if it had been available for the period illustrated. While the election results in no difference in the economic performance of the funding strategy, electing FAS 159 hedges Earnings Per Share (EPS) against asset return volatility. Assumptions: without FAS 159 election, assets are classified as Available for Sale under FAS 115 with unrealized gains (or losses) booked to Other Comprehensive Income; 1,000,000 shares; liability crediting rate based on historical returns 1996 to 2006 on a notional investment portfolio of 60% S&P500 Index/40% Lehman Aggregate Bond Index; corporate assets invested with the same allocation assuming 0% turnover and a 40% tax rate. 70% dividend exclusion has been ignored.

How does the availability of the FAS 159 election change the funding strategy decision? Consider the following.

Many sponsors fund nonqualified plans with Corporate-Owned Life Insurance (COLI) because the accounting treatment applied to COLI has been more favorable than that applied to a similar taxable investment strategy. This is because the changes in participant account balances (i.e. the liabilities) which are fully marked to market through the income statement can be closely matched by changes in COLI cash values which are also fully marked-to-market through the income statement in accordance with T.B. 85-4 and EITF 2006-5. In contrast, only the realized gains/losses and income return from a non-COLI funding strategy flow through the income statement (assuming those non-COLI assets are classified as Available for Sale under FAS 115). The result of the accounting differences between the two funding strategies has been that COLI has generally provided the better P&L hedge.

However, since applying a FAS 159 election will provide the ability to mark to market the full change of a taxable investment, including unrealized gains and losses, through P&L, COLI no longer will have an accounting advantage over a taxable investment strategy. In effect, a FAS 159 election levels the accounting playing field for the two funding strategies. With a FAS 159 election in place, a decision to informally fund (or continue funding) a nonqualified plan liability with COLI now rests where it should —on its risk- and tax-adjusted financial performance. Accounting cosmetics should no longer influence the choice between these two nonqualified funding strategies. Instead, the financial expectations of the investment relative to the sponsor's plan funding objectives and constraints will drive the sponsor's funding strategy choices.

Plan sponsors will need guidance from their auditors prior to implementing a FAS 159 election. For example, FAS 159 requires that the entity disclose what assets the fair value option has been applied to as well as why the fair value option has been selected. In addition, it appears that if the election is not made on the date FAS 159 becomes effective, any election made subsequent to that date might be restricted to the dates

on which the asset is purchased. For sponsors with increasing nonqualified plan liabilities due to increased participation and deferrals, but who are already "locked in" to existing COLI funding, a FAS 159 election for new assets may allow a multiple asset strategy that can better match the liabilities.

If you have any questions about nonqualified plan funding strategies, please contact Bill Bowden at 678.742.2434 or [William.J.Bowden@buckconsultants.com](mailto:William.J.Bowden@buckconsultants.com). Buck Consultants provides plan design, funding analysis, and record-keeping services to for-profit and not-for-profit sponsors, nationwide.

### ABOUT THE AUTHORS

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