

Case 94-5

A No Cost Deferred Compensation Arrangement

There is a flurry of activity at the Arkin Saw and Tool Company in Little Rock today. It's just after year-end, and Bill Jones, Hillary Carson, Al Manning, and Tipper Clark (management) are preparing for a meeting with the auditors to review the accounting for Arkin's deferred compensation arrangements (the Plan) for the year ended November 30, 1992. A new partner, George Quayle, has just been assigned to Arkin and he is expected to challenge all aspects of Arkin's reporting. Arkin is privately-held and does not issue quarterly financial statements.

Management is understandably nervous about the meeting. Arkin's Plan is extremely generous, everyone is just a little bit confused about how the Plan works, and the Company has not been doing well lately. They are all aware that Statement of Financial Accounting Standards (SFAS) No. 106 might have to be adopted for this Plan and that additional costs might have to be accrued.

In preparation for the meeting, Management reviews the terms of the Plan which covers 60 executives. The Plan document indicates that the arrangement is offered to certain management employees to encourage them to continue employment with Arkin until retirement.

A copy of the Plan document describes the key terms as follows:

- Executives are required to complete participation agreement forms each year to indicate whether they will participate in the plan that year and, if so, the amount they will defer.
- Arkin guarantees a 20% return on the amounts deferred after 25 years of service. If employees leave before 25 years of service they are entitled to their contributions plus a specified savings rate of return.
- Annuity payments begin at age 65. If employees leave after 25 years of service, they are entitled to the higher return upon reaching age 65. (They are not required to retire from the Company.)
- Amounts deferred are contributed to a trust. Trust assets are considered to be the property of Arkin and the trust is responsible for disbursing funds to plan participants as instructed by Arkin.
- Arkin may terminate or change the terms of the plan at any time.

There are no covenants not to compete or requirements that the individuals be available to provide consulting services after retirement. The plan trust uses contributed funds to purchase life insurance policies that are designed to provide annuity payments beginning at age 65. Benefits are paid either out of the cash surrender value of the policies or the excess proceeds from death benefits on policies held for employees who die before they receive all of their benefits. (The excess proceeds are the amount that remains after the required death benefit has been paid to the beneficiaries.)

Hillary asks Bill about Arkin's accounting policy to date and Bill explains that Arkin has been accruing the cost of the benefit over the service period to expected retirement. He also explains that SFAS Statement No. 106 establishes new requirements for deferred compensation arrangements, among them a requirement that the obligation be fully accrued at the full eligibility date. At present, the accrued obligation is about equal to the cash surrender value of the insurance policies held by the trust.

Based on the information provided on SFAS No. 106, management requested an analysis of the ramifications of a change in the accrual period and determined that if the benefits of all executives who have completed 25 years of service were fully accrued, the cumulative effect of the change would be approximately \$7 million.

Tipper states that she and Al recently met with Ross Monroe, owner of 60% of the outstanding stock of Arkin. They believe Mr. Monroe would react rather unfavorably to this charge to income, to put it mildly. Also, Management agrees that they would prefer not to call attention to this plan. The insurance company had sold this plan as a no-cost, no-effect-on-income plan. That is, the intent was to set up a "self funding" mechanism so that participant contributions plus death benefits in excess of the amounts to be paid to beneficiaries would be sufficient to meet the target benefit and repay the Company for premium contributions if made.

Because the accrual period historically ended at expected retirement, the related costs to Arkin were largely offset by increases in the cash surrender value of the insurance policies so that the income statement effect was negligible. There were also no separate disclosures about this arrangement in the financial statements; rather, the arrangement was included with other deferred compensation arrangements in the footnotes.

With a shorter accrual period, Bill explains, the matching effect will be lost, and although there will be no effect on cash flows, costs will no longer be invisible. They all agree that this result seems inconsistent with their intent with respect to this plan.

Required:

- How should Arkin account for the benefits provided under this deferred compensation arrangement?