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FASB'S EITF SHUTS DOWN USE OF RABBI TRUSTS BY COMPANIES TO DIVERSIFY DEFERRED STOCK INTO OTHER INVESTMENTS AND TO PAY OUT IN CASH WITHOUT AN EARNINGS CHARGE

SUMMARY

The FASB's EITF recently ruled that the use of a rabbi trust to convert executives' deferred stock accounts to cash which is paid out to an executive when the deferral period is over does not protect the company's earnings from growth in stock price during the deferral period.[*] Those familiar with APB No. 25, *Accounting for Stock Issued to Employees,* may wonder why this issue ever came up since APB No. 25 is clear at ¶11g. that "cash paid to an employee to settle an earlier award of stock…should measure compensation cost." Nonetheless, effective March 19, 1998, deferred stock placed in a rabbi trust cannot be diversified or paid out in cash without an earnings charge for changes in value during the deferral period. To protect the earnings statement from expense for stock price growth during a deferral period, deferred stock *must* be paid out in actual shares of company stock.

BACKGROUND

The Emerging Issues Task Force (EITF) is the technical arm of the FASB charged with interpreting GAAP in special applications. It finished its work on Issue No. 97-14, *Accounting for Deferred Compensation Arrangements Where Amounts Earned Are Held in a Rabbi Trust and Invested,* on July 23. EITF 97-14 deals with the relatively rare situation where an executive defers compensation into company stock, or defers an option gain into company stock, and the deferred stock is placed in a "rabbi trust" and then sold for cash. The cash proceeds may be reinvested. At distribution, the executive receives cash for the value of his or her investment account. The question dealt with by the EITF was whether the accounting expense for P&L purposes is limited to the value of the company stock when compensation was first deferred or is the value of the cash distributed to the executive when the deferral period is over.

EITF FINDINGS

The key EITF findings in Issue 97-14 are:

1. Assets placed in a rabbi trust for the benefit of executives should be consolidated in the company's financial statements

   — Rabbi trust assets are assets of the company available to creditors

[*] EITF Issue 97-14, July 23, 1998

2. Company stock placed in a rabbi trust to meet deferred compensation obligations to executives should be classified as treasury stock

3. If the company stock held by the rabbi trust can be sold and the proceeds diversified or paid to the executive in cash, the company's deferred compensation liability should be adjusted to reflect changes in the amount of deferred compensation owed to the executive

   — This change in value (up or down) should be run through the income statement as a charge (or credit) to compensation expense

4. If, however, stock is held by the rabbi trust and *cannot be sold*, but rather is required to be paid out to the executive in actual shares when the deferral period is over, then the deferred compensation liability should not be marked to market

   — There would be no charge (or credit) to earnings for growth (or decline) in stock value during the deferral period

The EITF reached these decisions on March 18-19, 1998, and set March 19 as the effective date. The SEC observer objected to applying the conclusions only prospectively because accounting literature was relatively clear all along as to what the conclusions should be.

TRANSITION ISSUES

At a follow-up meeting on May 21, the EITF discussed two transition alternatives: (1) EITF conclusions in Issue 97-14 only apply to compensation deferred after March 19, 1998 (pre-existing deferral arrangements can retain the accounting treatment used prior to March 19), or (2) adjustments to earnings required to adopt the EITF's conclusions may be treated as a change in accounting principle in the current period's financial statements. On July 23, 1998, the EITF continued its discussion and reached a final consensus on Issue 97-14 by deciding as follows with respect to transition issues:

1. If the deferred stock plan does not permit diversification and requires settlement in a fixed number of shares, no change is required in compensation expense for changes in market value during the deferral period

2. If the deferred stock plan permits diversification or payout of deferred stock in cash, then the difference between the original cost of the shares acquired by the rabbi trust and their value on September 30, 1998, should be recorded in a contra-equity account (the "transition differential"), with a corresponding change in deferred compensation liability, but no charge to earnings

   — Changes in stock value after September 30 would be charged to earnings if they exceed the amount in the contra-equity account, unless the company amends the plan to prohibit stock payouts in cash

3. If the stock in the rabbi trust has already been sold for diversification, deferred compensation liability should be adjusted for the value of trust assets as of September 30, 1998

   — There would be no charge/credit to compensation expense for difference between September 30 value and the original deferred compensation amount

Instead of setting up a contra-equity account for changes in stock price between acquisition date and September 30, with its corresponding requirement to keep track of amounts <u>not</u> previously charged to expense (see item 2 above), the company may elect to run the "transition differential" through earnings as a cumulative effect of a change in accounting principle.

EPS EFFECT OF DEFERRED STOCK

The EITF also concluded that an obligation to pay out deferred stock in actual shares (as opposed to cash) requires that such shares be included in shares outstanding for Basic and Diluted EPS purposes during the deferral period under FAS 128, <u>Earnings Per Share</u>. If the deferred stock obligation may be settled in actual shares <u>or</u> cash, then the changes in value of those shares during the deferral period would affect Basic EPS (by affecting net income), but the shares themselves would not be included in Diluted EPS. All EPS calculations allow anticipated tax savings from the ultimate tax deductibility of deferred stock payouts to be used to reduce the effect of deferred stock on EPS.

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Companies which do not permit executives' non-qualified deferred stock accounts to be diversified or paid out in cash will not be affected by EITF Issue 97-14. Those that use rabbi trusts to permit diversification of deferred stock accounts or payout in cash are directly affected. The conclusions in Issue 97-14 *may* be applicable to those that permit payout of deferred stock balances in cash, even if a rabbi trust is not used. Those that do so should reexamine their practices and the effect on earnings and consider amending their plans to prohibit diversification and to require payout of deferred stock balances in actual shares for new and old deferrals going forward.

This letter is based on our general interpretations of EITF 97-14 and related issue papers. General questions may be addressed to Fred Cook at 212-986-6330. Questions specific to a company's particular situation should be addressed to the company's accounting staff or auditors. Readers are invited to visit our website at FredericWCook.com for information on this and other subjects we have written about in the past.