

Governmental Accounting Standards Series

EXPOSURE DRAFT

Proposed Statement of the Governmental Accounting Standards Board

**Accounting and Financial Reporting for Internal Revenue
Code Section 457 Deferred Compensation Plans**

**a rescission of GASB Statement No. 2 and
an amendment of GASB Statement No. 31**

This Exposure Draft of a proposed Statement of Governmental Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research
Project No. 25-6

Comment Deadline: August 19, 1997



GOVERNMENTAL ACCOUNTING STANDARDS BOARD
OF THE FINANCIAL ACCOUNTING FOUNDATION

WRITTEN COMMENTS

Deadline for submitting written comments: August 19, 1997.

Requirements for written comments: Comments should be addressed to the Director of Research, Project No. 25-6. Comments can also be submitted by electronic mail to: director@gasb.org.

OTHER INFORMATION

Public hearing. The Board has not scheduled a public hearing on the issues addressed in this Exposure Draft.

Public files. Written comments will become part of the Board's public file and will be available for inspection at the Board's offices. Copies of these materials may be obtained for a specified charge.

Orders. Any individual or organization may obtain one copy of this Exposure Draft on request without charge until August 19, 1997, by writing or phoning the GASB. For information on prices for additional copies and copies requested after August 19, please contact the Order Department at the address shown below.

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**Notice to Recipients
of This Exposure Draft**

The Governmental Accounting Standards Board is responsible for developing standards of state and local governmental accounting and financial reporting that will (a) result in useful information for users of financial reports and (b) guide and educate the public, including issuers, auditors, and users of those financial reports.

The due process procedures that we follow before issuing our standards and interpretations are designed to encourage broad public participation in the standards-setting process. As part of that due process, we are issuing this Exposure Draft (ED) setting forth a proposed Statement of accounting and financial reporting standards for Internal Revenue Code Section 457 deferred compensation plans of state and local governmental employers.

The Board will consider all matters before issuing a final document. Because the ED may be modified before its issuance as a final Statement, it is important that you respond even if you agree with the Board's proposal.

All comments are distributed to the Board and to staff members assigned to this project, and all comments are considered when we deliberate on the final Statement. When we are satisfied that all reasonable alternatives have been considered adequately, the Board votes on the Statement. A majority vote is required for adoption of the final Statement.

Summary

This proposed Statement would rescind GASB Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457*, and would establish accounting and financial reporting standards for Internal Revenue Code Section 457 deferred compensation plans of state and local governmental employers. In addition, this proposed Statement would amend the investment guidance for Section 457 plans in GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*.

The provisions of this proposed Statement would be effective for financial statements for periods beginning after December 31, 1998 or when plan assets are held in trust under the requirements of IRC Section 457, subsection (g), if sooner.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments, public benefit corporations and authorities, public employee retirement systems, utilities, hospitals and other healthcare providers, and colleges and universities. Paragraphs 2 and 3 discuss the applicability of this Statement.

Proposed Statement of the Governmental Accounting Standards Board

**Accounting and Financial Reporting for Internal Revenue Code
Section 457 Deferred Compensation Plans**

**a rescission of GASB Statement No. 2 and an amendment of
GASB Statement No. 31**

June 20, 1997

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Proposed Statement of the Governmental Accounting Standards Board

**Accounting and Financial Reporting for Internal Revenue Code
Section 457 Deferred Compensation Plans**

**a rescission of GASB Statement No. 2 and an amendment of
GASB Statement No. 31**

June 20, 1997

INTRODUCTION

1. GASB Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457*, established reporting requirements for IRC Section 457 plans. Based on the laws in effect at the time of its passage, that Statement required that all amounts deferred by the plan participants remain the property of the employer until made available to the participants or their beneficiaries. The laws governing these plans were changed to state that as of August 20, 1996, new plans will not be considered eligible plans "unless all assets and income of the plan described in subsection (b)(6) are held in trust for the exclusive benefit of the participants and their beneficiaries."¹ Existing plans also are required to comply with this requirement by January 1, 1999.

**STANDARDS OF GOVERNMENTAL ACCOUNTING AND
FINANCIAL REPORTING**

Scope and Applicability of This Statement

2. This Statement establishes accounting and financial reporting standards for Internal Revenue Code Section 457 deferred compensation plans of state and local governments.
3. This Statement supersedes Statement 2 and amends GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, paragraph 2, by removing the exclusion of IRC Sec-

¹IRC Section 457, subsection (g)(1).

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tion 457 plans from that paragraph. This Statement also amends paragraph 4 of Statement 31 by removing the references to Statement 2 and deferred compensation plans.

Reporting

4. An IRC Section 457 deferred compensation plan that meets the criteria in NCGA Statement No. 1, *Governmental Accounting and Financial Reporting Principles*, paragraph 26(3)(8), for inclusion in the fiduciary funds of a government should be reported as an expendable trust fund in the financial statements of that government.

Valuation

5. IRC Section 457 plans should apply the valuation provisions of Statement 31 to plan investments listed in subparagraphs 2a through e of that Statement. All other plan investments should be reported at fair value.

6. If it is impractical to obtain investment valuation information from the plan administrator as of the reporting government's balance sheet date, the most recent report of the administrator should be used—for example, reports ending within the reporting government's fiscal year or shortly thereafter, adjusted for interim contributions and withdrawals.

EFFECTIVE DATE AND TRANSITION

7. The provisions of this Statement are effective for financial statements for periods beginning after December 31, 1998. If a government complies with the requirements of subsection (g) of IRC Section 457 before that date, early application of this Statement is required for the financial reporting period in which compliance occurs. Accounting changes adopted to conform to the provisions of this Statement should not be applied retroactively. The cumulative effect of applying this Statement, if any, should be reported as a restatement of beginning fund balance for the earliest period reported. In the period this Statement is first applied, the financial statements should disclose the nature of the change and its effect.

**The provisions of this Statement need
not be applied to immaterial items.**

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Appendix A

BACKGROUND INFORMATION

8. IRC Section 457 enables state and local governments to establish eligible deferred compensation plans for their employees subject to certain requirements. Prior to August 20, 1996, subsection (b)(6) of IRC Section 457 required the following:

All amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights, shall remain (until made available to the participant or other beneficiary) solely the property and rights of the State . . . subject only to the claims of the state's general creditors.

9. To provide for consistent accounting and reporting for IRC Section 457 deferred compensation plans, the Board issued Statement No. 2, *Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457*. Because the assets of the plan remained the property of the government, Statement 2 required that an IRC Section 457 plan be reported in the financial statements of the governmental entity that sponsors the plan, even if the plan's assets are administered by a third party. To express the fact that, although the government owned the plan assets, it had a contractual liability to plan participants, Statement 2 required that the amount contractually owed to plan participants be reported as a liability in an agency fund.

10. On August 20, 1996, the provisions of IRC Section 457 were amended by adding subsection (g). That subsection states, in part, the following:

A plan . . . shall not be treated as an eligible deferred compensation plan unless all assets and income of the plan described in subsection (b)(6) are held in trust for the exclusive benefit of participants and their beneficiaries. . . .

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11. That subsection also explains the effective date for existing plans:

In the case of a plan in existence on the date of the enactment of this Act, a trust need not be established by reason of the amendments made by this section before January 1, 1999.

12. Under these new requirements, the government no longer owns the amounts deferred by employees and related income on those amounts. This change necessitated a reexamination of the guidance provided in Statement 2.

Appendix B

BASIS FOR CONCLUSIONS

Introduction and Overview

13. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes discussion of the alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

Scope of This Statement

14. This Statement rescinds GASB Statement 2, which was issued to resolve accounting issues that resulted from a unique characteristic of IRC Section 457 deferred compensation plans at that time—the fact that, until distributed, the plans' assets belonged to the governments, not the employees. That unique characteristic does not exist for plans that follow the provisions of subsection (g). The Board considered whether it should simply rescind Statement 2 without issuing new guidance in its place. The Board has not issued accounting and reporting guidance for other deferred compensation plans or for plans that have similarities to these new Section 457 plans (for example, 401(k) and 403(b) plans of governments). However, the Board believes that this Statement will reduce confusion regarding accounting and reporting for Section 457 plans under the revised IRC provisions.

15. This Statement also expands the scope of Statement 31 to include debt and equity investments of Section 457 plans. This amendment to Statement 31 will replace a significant portion of the investment valuation guidance previously provided in Statement 2. The rest of the investment valuation guidance previously provided in Statement 2 has been brought forward in substance to this Statement.

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Reporting

16. This Statement requires governments to report Section 457 plans if they meet the criteria in NCGA Statement 1, paragraph 26(3)(8), which reads as follows:

Fiduciary Funds—the Trust and Agency Funds—are used to account for assets held by a governmental unit in a trustee capacity or as an agent for individuals, private organizations, other governmental units, and/or other funds. . . . [These include (a) expendable trust funds, (b) nonexpendable trust funds, (c) pension trust funds, and (d) agency funds.]

17. Research conducted by the Board indicates that most sponsors of Section 457 plans have little administrative involvement and do not perform the investing function for those plans. The Board acknowledges that governments will need to exercise judgment in determining whether they have fiduciary accountability for Section 457 plans and whether they hold the assets in a trustee capacity. However, this is consistent with practice for other types of plans; governments that have 401(k) or 403(b) plans or other deferred compensation plans currently determine if these criteria apply to those plans.

18. Section 457 plans typically involve long-term investment and may have some degree of management involvement. Those are characteristics of activities reported in trust funds, as opposed to agency funds which generally involve temporary investment and little management involvement. Therefore, under the revised IRC provisions, Section 457 plans that meet the criteria for inclusion in the fiduciary funds of a government should be reported as trust funds.

19. The Board believes that Section 457 plans, when reported, should be reported as expendable trust funds because the other types of trust funds are inappropriate. For example, the nonexpendable trust fund presumes that the corpus is not expendable—this is not true for Section 457 plans. Also, the Board does not regard Section 457 plans as pension trust funds.

Valuation of Investments

20. For debt and equity investments, the Board believes the fair value standards that Statement 2 established are maintained by expanding the scope of Statement 31, subparagraphs 2a through e, to encompass Section 457 plans.

The Board notes that this also extends the fair value exceptions of Statement 31 to include debt and equity investments of Section 457 plans. In those instances in which governments report their plans under this Statement, the Board does not believe that this will significantly change the way those plans' investments are reported.

21. For investments not covered by subparagraphs 2a through e of Statement 31, this Statement incorporates the fair value requirements that Statement 2 had established.

Note Disclosures

22. As part of the Board's research on note disclosures, focus groups ranked the disclosures required by Statement 2 for Section 457 plans as among the least important. Furthermore, the Board is unaware of any additional risks to plan sponsors, under the revised IRC provisions, that would require additional disclosures. Therefore, this Statement does not require specific note disclosures.

Appendix C

CODIFICATION INSTRUCTIONS

23. The sections that follow update the June 30, 1996, *Codification of Governmental Accounting and Financial Reporting Standards* for the effects of this Statement. Only the paragraph number of this Statement is listed if the paragraph will be cited in full in the Codification.

* * *

LONG-TERM LIABILITIES

SECTION 1500

.111 [Eliminate paragraph and renumber remaining paragraphs.]

* * *

NOTES TO THE FINANCIAL STATEMENTS

SECTION 2300

.107 [Eliminate subparagraph u and re-letter remaining subparagraphs.]

* * *

**DEFERRED COMPENSATION PLANS
(IRC SECTION 457)**

SECTION D25

[Revise entire section as follows:]

Source: GASB Statement XX

Reporting

.101 [GASBS XX, ¶4] [Change cross-reference.]

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Valuation

.102 [GASBS XX, ¶5] [Change *Statement* to *section* and change cross-reference.]

.103 [GASBS XX, ¶6]

* * *

COLLEGES AND UNIVERSITIES

SECTION Co5

Sources: [Delete reference to GASB Statement 2 and add GASB Statement XX.]

.102 [Delete GASBS 2 from sources and add GASBS XX.]

* * *

NOT-FOR-PROFIT ACCOUNTING AND FINANCIAL REPORTING

SECTION No80

Sources: [Delete reference to GASB Statement 2 and add GASB Statement XX.]

.103 [Delete GASBS 2 from sources and add GASBS XX.]