

# Governmental Accounting Standards Series

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**[Completely Superseded]**

Statement No. 2 of the  
Governmental Accounting  
Standards Board

**Financial Reporting of Deferred  
Compensation Plans Adopted  
under the Provisions of Internal  
Revenue Code Section 457**



Governmental Accounting Standards Board  
of the Financial Accounting Foundation

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### **Summary**

This Statement requires that, for employers using governmental fund accounting, Internal Revenue Code (IRC) Section 457 deferred compensation plan balances be displayed in an agency fund of the governmental employer that has legal access to the resources, whether the assets are held by the employer, a public employee retirement system (PERS), a nongovernmental third party, or another governmental entity under a multiple-jurisdiction plan. Governmental public utilities and public authorities should report the liability in the balance sheet with a corresponding designated asset.

Note disclosure is required of (a) the requirement of IRC Section 457 that the assets in the plan remain the property of the employer until paid or made available to participants, subject only to the claims of the government's general creditors, and (b) the government's fiduciary responsibilities under the plan.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including public benefit corporations and authorities, public employee retirement systems, and governmental utilities, hospitals, colleges, and universities.
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Revenue Code Section 457

January 1986



**Governmental Accounting Standards Board**  
of the Financial Accounting Foundation  
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**Statement No. 2 of the Governmental Accounting Standards Board**

**Financial Reporting of Deferred Compensation Plans Adopted under the Provisions  
of Internal Revenue Code Section 457**

**January 1986**

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# [Completely Superseded]

## Statement No. 2 of the Governmental Accounting Standards Board

### Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457

January 1986

#### INTRODUCTION AND BACKGROUND INFORMATION

1. Deferred compensation plans offer employees the opportunity to defer receipt of a portion of their salary and the related liability for federal income taxes. Several sections of the Internal Revenue Code (IRC) authorize certain state and local governments to provide deferred compensation plans for their employees. This Statement deals only with deferred compensation plans authorized by IRC Section 457.

2. IRC Section 457 enables state and local governments to establish eligible deferred compensation plans for their employees subject to these requirements, as enumerated in IRC Section 457(b)(6):

- a. All amounts of compensation deferred under the plan,
- b. All property and rights purchased with such amounts, and
- c. 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 (without being restricted to the provision of benefits under the plan) subject only to the claims of the state's general creditors.<sup>1</sup>

Liability for federal income taxes under IRC Section 457 plans is deferred until the funds are withdrawn by the participant or designated beneficiary in accordance with the terms of the agreement, that is, after the participant becomes eligible to withdraw funds upon termination, retirement, death, or unforeseeable emergency.

3. The provisions of this Statement do not apply to other deferred compensation plans in which the deferred amounts are not required to be considered assets of the employer government and are not subject to the claims of the employer's general creditors.

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<sup>1</sup>The term *state* in this context is defined as a state, a political subdivision of a state, or any agency or instrumentality of a state or political subdivision of a state.

## [Completely Superseded]

4. IRC Section 457 deferred compensation plans are administered by either a designated governmental entity or an independent plan administrator. Generally, the administrator invests the deferred amounts as directed by the participants, maintains detailed accounting records of individual participants' deferrals and earnings, and disburses funds to the plan participants under the terms of the deferred compensation agreement. Frequently, the plans acknowledge that the governmental entity is responsible for "due care" in managing the investments and in selecting the third-party administrator. In the typical deferred compensation agreement, the participant or beneficiary assumes the risk of loss from decreases in the value of the plan's assets. The governmental entity is liable to plan participants only to the extent of their pro rata shares of the market value of the plan assets.

5. IRC Section 457 does not prohibit "unfunded" deferred compensation plans. In unfunded plans, the deferred amounts are not transferred to separate investment accounts but instead remain in the salary-paying fund as an asset of that fund. The deferred compensation liability in those plans is based on a promise to pay a certain amount in the future (for example, the deferred amount plus interest accrued at a stated rate).

6. Legally, the amounts deferred are the property of the employer, even though the funds have been earned by the employee and represent a portion of the employee's gross salary. Legal ownership of the plan assets does not vest with the employee until those amounts become due and payable to the employee under the terms of the plan. A participant who becomes eligible to receive distributions from the plan but chooses instead to receive the deferred amounts over a period of time remains a general creditor the same as those participants who are still active or otherwise ineligible. If the deferred amounts and related earnings are placed in a legal trust for the participants or are otherwise beyond the reach of the government or its general creditors at any time before actual payment, these amounts become taxable income to the participants.

7. IRC Section 457 does not require a specific method of financial reporting; it itemizes the circumstances that must exist for the deferred compensation plan to be eligible for tax deferral. A governmental entity customarily requests a ruling from the Internal Revenue Service (IRS) on the eligibility of its deferred compensation plan. The IRS, through the rulings process, examines the provisions of the individual plans and determines compliance with IRC Section 457.

## [Completely Superseded]

8. The topic of IRC Section 457 deferred compensation plans was placed on the GASB project agenda because financial reporting of the plans varied significantly. That variety appears to be a function of different perceptions or interpretations of the relationship that exists between the governmental entity and the funds held for the individual plan participants. By law, the deferred amounts and related earnings are accessible to the governmental entity and its creditors; however, the employees have earned those amounts and the governmental entity is contractually obligated to pay them. In effect, the employee temporarily loses access to the resources in exchange for the right to defer federal taxes on them.

### **STANDARD OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING**

9. *Employers using governmental fund accounting.* IRC Section 457 deferred compensation plan balances should be displayed in an agency fund of the governmental employer that has legal access to the resources, whether the assets are held by the employer, a public employee retirement system (PERS), a nongovernmental third party, or another governmental entity under a multiple-jurisdiction plan. The balance sheet should display the plan assets with a corresponding liability to employees for deferred compensation and accumulated net earnings thereon. When an employer that uses governmental fund accounting is the administrator of a multiple-jurisdiction plan, it should display all the assets and liabilities in an agency fund since that entity is acting as an agent for both its own employees and the other governments participating in the plan.

10. *Employers using proprietary fund accounting.* Separately constituted governmental public utilities and public authorities should display the deferred compensation liability in the balance sheet with a corresponding asset identified as designated for deferred compensation benefits. Such display is required whether the assets are held by the employer, a PERS, a nongovernmental third party, or another governmental entity under a multiple-jurisdiction plan. These display requirements also apply to proprietary-type and similar trust funds of a general governmental reporting entity, provided those funds have *separate* plans for their employees. These requirements do not apply to proprietary-type and similar trust funds that do *not* have separate plans. The liability for deferred compensation plans for proprietary-type and similar trust fund activities that do not have separate plans would be included in an agency fund of the governmental employer that has legal access to the resources pursuant to paragraph 9.

## **[Completely Superseded]**

11. The employer's liability to each participant, at any point in time, is measured by the participant's share of the market value of the plan assets; therefore, plan assets should be valued at market. If the obligation to plan participants is determined by a measurement other than market value (such as fixed-rate insurance contracts), the same method used to calculate the obligation by the administrator (for example, contract value) should be used to value the assets. If it is impractical to obtain investment valuation information from the administrator as of the balance sheet date of the reporting government, 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.

12. The liability for unfunded deferred compensation plans, discussed in paragraph 5, should include all deferred amounts including accrued interest and should be reported as a liability of the salary-paying fund (a) to show the government's contractual commitment to the employees and (b) to recognize compensation and interest expense/expenditure at the time the deferred compensation is earned or the interest is incurred. No portion of the liability should be reported in the general long-term debt account group. An agency fund should not be established to report unfunded plans. However, when the employer uses assets from an established agency fund for purposes other than the payment of benefits, the amounts used should be reported in the agency fund as a receivable from other funds.

13. The governmental employer should disclose its stewardship responsibility under the plan and the legal and contractual features of the agreements. Disclosure should include (a) the requirement of IRC Section 457 that the assets in the plan remain the property of the employer until paid or made available to participants, subject only to the claims of the government's general creditors, and (b) a statement of the government's fiduciary responsibilities under the plan. If the plan assets have been used in the past for purposes other than the payment of benefits, disclosure should be made of such use. The administering governmental entity in a multiple-jurisdiction plan should also disclose that portion of the assets in the fund to which it has legal access, as distinguished from the assets held for other participating governmental employers. (See Appendix B for an illustration of note disclosure.)

14. There is a potential for duplicate reporting of deferred compensation amounts when a PERS administers an IRC Section 457 plan and the PERS financial data are combined with those of participating governmental employers that are part of the reporting entity. To

## **[Completely Superseded]**

avoid duplication, (a) deferred compensation amounts applicable to the oversight unit should be included only once in the trust and agency fund column of the combined financial statements and (b) deferred compensation amounts applicable to other component units of the entity should be included only in the appropriate columns applicable to those component units. Regardless of the method used in separate financial statements issued by a PERS to report the deferred compensation amounts it administers, such amounts should be displayed as an agency fund, as described in paragraph 9, when included in the combined financial statements of the reporting entity. Note disclosure should be made of the portion of the deferred compensation assets administered by the PERS for all participating governmental employers not part of the reporting entity, as described in paragraph 13. Duplication should also be avoided in combined financial statements by following the guidance in (b) above if the oversight unit administers a multiple-employer deferred compensation plan and some of those employers are part of the reporting entity.

### **EFFECTIVE DATE AND TRANSITION**

15. The provisions of this Statement are effective for financial statements for periods ending after December 15, 1986. Earlier application is encouraged. Adjustments resulting from a change to comply with these principles should be treated as an adjustment of prior periods, and financial statements presented for the periods affected should be restated. In the year in which this Statement is first applied, the financial statements should disclose the nature of any restatement and its effect. If restatement of financial statements for prior periods presented is not practical, the cumulative effect of applying these principles should be reported as a restatement of the beginning fund balance or retained earnings (as appropriate) for the earliest period restated. Also, the reason for not restating all prior periods presented should be explained.

<p><b>The provisions of this Statement need not be applied to immaterial items.</b></p>
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**[Completely Superseded]**

*This Statement was adopted by the unanimous vote of the five members of the Governmental Accounting Standards Board:*

James F. Antonio, *Chairman*

Martin Ives, *Vice-Chairman*

Philip L. Defliese

W. Gary Harmer

Elmer B. Staats

## [Completely Superseded]

### Appendix A

#### BASIS FOR CONCLUSIONS

16. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes descriptions 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.

17. State and local governments establish IRC Section 457 deferred compensation plans as a form of payroll fringe benefit for their employees, providing both a convenient way to save and a means of sheltering a portion of their salaries from federal taxation, not to provide a source of working capital to the governmental unit.

18. As a going concern, a governmental entity that maintains an IRC Section 457 plan in good faith would not be expected to access or permanently diminish the assets of the plan for purposes other than to provide benefits, even though it has a legal right to do so. Consequently, the substance of these plans is that the government is acting in a fiduciary capacity for the participating employees and that the deferred amounts will ultimately be paid to the employees as agreed. The GASB concluded that a governmental entity's financial statements should display the economic substance of the deferred compensation transactions; it should portray the fiduciary relationship between the governmental entity and its participating employees, as well as disclose the potential access of the government and its creditors to both the deferred compensation and the earnings on those funds.

19. A Discussion Memorandum (DM), *Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457 for State and Local Government Employees*, was issued by the GASB on February 15, 1985. The GASB received 68 letters of comment on the DM. The comments received were helpful and provided the Board with valuable input during its deliberations on these issues. Varying degrees of support were expressed for each of the display and disclosure alternatives addressed in the DM, as well as other methods. A majority of respondents to the DM preferred fiduciary fund reporting although there was no clear majority for any particular fiduciary fund. There was also support for reporting the plans in the general fund or other salary-paying fund. Some of the respondents advocated note disclosure only, with no financial statement display.

## [Completely Superseded]

20. A majority of the Board believe that deferred compensation transactions result in both an asset and a liability from the governmental employer's perspective. There is a liability in the sense that, contractually, the deferred amounts are owed to the employees. The asset represents an amount held for employees but available to the employer. The Board concluded that note disclosure only is equivalent to "offsetting." Accounting Principles Board Opinion No. 10, *Omnibus Opinion—1966*, states, "It is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists" (paragraph 7-1). Right of offset does not exist for deferred compensation until it is made available to the participant, generally the actual date of disbursement from the plan.

21. The Board also considered display in the general fund. However, a majority of the Board members believe this display is inappropriate because it is based solely on the legal form of the deferred compensation plan, not on its economic substance. The Board determined that, within the context of the existing fund structure, general fund display could be misleading because the likelihood of access to the resources by the government or its creditors is remote. Despite the legal availability of the deferred compensation assets to the government and its creditors, the Board believes displaying the fiduciary relationship with employees (with appropriate disclosure of the availability of the plan assets to the government and its creditors) more nearly conveys the substance of the transactions.

22. The Board then considered the fiduciary fund alternatives. Some Board members prefer trust fund display but believe that treating the accumulated credit as fund balance does not adequately convey the substance of the situation; that is, on one hand the governmental employer has legal ownership of the plan assets, but on the other hand it is contractually obligated to pay the amounts as deferred compensation benefits. From another perspective, the employees do not own the assets, but they have a contractual right to receive them. Therefore, the Board concluded that the best way to express this relationship is to display the accumulated credit as a liability to the employees within the fiduciary funds, rather than as a fund balance.

23. Within the context of the current accounting model, agency funds provide that display, since they have only assets and liabilities, and all transactions represent either increases or decreases of assets and liabilities. Based on this, the Board agreed to require agency fund display with note disclosure of (a) the requirement of IRC Section 457 that

## [Completely Superseded]

the assets in the plan remain the property of the employer until paid or made available to participants, subject only to the claims of the government's general creditors, and (b) the government's fiduciary responsibilities under the plan.

24. An Exposure Draft (ED) of a proposed Statement, *Financial Reporting of Deferred Compensation Plans Adopted under the Provisions of Internal Revenue Code Section 457 for State and Local Government Employees*, was issued by the GASB on September 20, 1985. The GASB received 57 letters of comment on the ED. A majority of the respondents agreed with the major provisions of the ED. However, certain changes were made to the proposed Statement as a result of the respondents' recommendations.

25. The ED contained reporting requirements for separately issued statements of PERS that administer IRC Section 457 plans. Some of the respondents recommended alternatives to the proposed reporting requirements. Upon reconsideration of the proposal, the Board concluded that reporting of IRC Section 457 deferred compensation plans by PERS or governmental administrators that issue separate reports might be considered in a separate GASB project. In the meantime, the Board acknowledges the existence of suitable guidance for separate reporting by plans in the AICPA Industry Audit Guide, *Audits of Employee Benefit Plans*, in the chapter on accounting and reporting by defined contribution plans and the related illustrative financial statements. If a PERS follows the Industry Audit Guide for IRC Section 457 plan reporting, the "net assets available for plan benefits" in the PERS report would be reported in the reporting entity's report as a liability in the agency fund used for the combined statements of the reporting entity, in accordance with paragraph 14 of this Statement.

26. Some respondents also objected to the proposed requirement to present investment performance data as required supplementary information. For a variety of reasons including the absence of standards for measuring investment performance, the Board agreed to eliminate this requirement. The Board believes, however, that such reporting is useful and encourages preparers to report appropriate investment performance data in the statistical section of a PERS or other separately issued reports on an IRC Section 457 plan.

27. Some respondents were concerned that the proposed requirement to disclose plan activity in a footnote while requiring display in an agency fund was inconsistent with current standards and practice. The Board agreed to eliminate this requirement because employees of those plans with which the Board is familiar receive annual statements and

## **[Completely Superseded]**

because separate reporting by administrators will yield more complete information. (See paragraph 25 above.)

28. Some respondents were also concerned that certain other conclusions were inconsistent with current standards applicable to other transactions in somewhat similar circumstances (namely, the use of agency funds for display, valuing investments at market, and reporting noncurrent unfunded deferred compensation as a liability in a governmental fund). Some respondents, for example, pointed out that “fund balance” in some trust funds could logically be reclassified as a liability, similar to deferred compensation. The GASB recognizes that apparent inconsistencies may result from attempting to provide timely guidance on emerging issues, particularly during its early years before basic principles have been reexamined. In fact, the Board’s deliberations on both this project and the pensions project indicate the need for addressing trust and agency funds in general. Pending such review, the conclusions in this Statement should not be construed as a basis for changing existing accounting and financial reporting methods for other fiduciary activities.

29. The IRS responded to a request by the GASB to comment on the propriety of the display and disclosure requirements as proposed in the ED. An excerpt from the IRS’s letter is reprinted as Appendix C of this Statement.

## **[Completely Superseded]**

### **Appendix B**

#### **ILLUSTRATION OF NOTE DISCLOSURE**

30. This appendix illustrates the application of the requirements of paragraph 13 of this Statement. It is presented for illustrative purposes only.

#### **Note XX Deferred Compensation Plan**

The State offers its employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all State employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency.

All amounts of compensation deferred under the plan, all property and rights purchased with those amounts, and all income attributable to those amounts, property, or rights are (until paid or made available to the employee or other beneficiary) solely the property and rights of the State (without being restricted to the provisions of benefits under the plan), subject only to the claims of the State's general creditors. Participants' rights under the plan are equal to those of general creditors of the State in an amount equal to the fair market value of the deferred account for each participant.

It is the opinion of the State's legal counsel that the State has no liability for losses under the plan but does have the duty of due care that would be required of an ordinary prudent investor. The State believes that it is unlikely that it will use the assets to satisfy the claims of general creditors in the future. [Note: Use as appropriate.]

\* \* \*

[Note: For governmental administrators of multiple-jurisdiction plans the preceding paragraphs should be adapted as appropriate, and information similar to the following should be disclosed as well.]

Of the \$33,987,500 in the plan at June 30, 19X2, \$22,812,500 was applicable to the State while the remaining \$11,175,000 represents the assets of the other jurisdictions participating in the plan.

## [Completely Superseded]

### Appendix C

#### INTERNAL REVENUE SERVICE CORRESPONDENCE

31. The following excerpt is taken from the Internal Revenue Service's letter to the GASB dated August 16, 1985. Copies of the complete letter are available from the GASB on request.

This is in response to your letters of April 3, 1985 and July 18, 1985, asking for our comments as to the appropriate method for governmental entities to display on financial statements the details regarding eligible State deferred compensation plans under section 457 of the Internal Revenue Code and the Income Tax Regulations thereunder.

The Governmental Accounting Standards Board (GASB) has concluded that any property and income attributable to compensation deferred under an eligible State deferred compensation plan should be reported on a governmental entity's financial statements as an agency fund. The amounts reported as an agency fund will appear as both an asset and a liability of the governmental entity on the balance sheet of the entity. In addition, the GASB recommends an explicit and detailed footnote regarding the State deferred compensation plan that indicates to all readers of the financial statements that 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, are (until made available to the employee or other beneficiary) solely the property and rights of the State (without being restricted to the provision of benefits under the plan), subject only to the claims of the State's general creditors.

Our concern about the method used to display the property and income attributable to deferrals under a State deferred compensation plan relates to section 1.457-2(j) of the regulations. Section 1.457-2(j) requires proper administration of a plan in order for the plan to be eligible and generally provides that, in actual administration of the plan, all assets attributable to the plan must remain the property of the State and subject to the general creditors of the State, without being restricted in any way to the provision of benefits under the plan. We believe that the method of financial statement display which the GASB recommends does not violate section 457 or the regulations thereunder.

# [Completely Superseded]

## Appendix D

### CODIFICATION INSTRUCTIONS

32. The sections that follow update the November 1, 1984 *Codification of Governmental Accounting and Financial Reporting Standards* for the effects of this Statement. Only the paragraph number is listed if the paragraph will be cited in full in the Codification.

\* \* \*

### FUND ACCOUNTING

### SECTION 1300

Sources: [Add the following:] GASB Statement 2

.104c(1) [Add the following at the end of the subparagraph:] IRC Section 457 deferred compensation plan balances should be displayed in an agency fund. (See Section D25, “Deferred Compensation Plans.”) [GASBS2, ¶9]

\* \* \*

### LONG-TERM LIABILITIES

### SECTION 1500

Sources: [Add the following:] GASB Statement 2

.108 [Add the following after the first sentence:] The long-term portion of liabilities accrued under “unfunded” IRC Section 457 deferred compensation agreements should be displayed as a liability of the related salary-paying fund. (See Section D25, “Deferred Compensation Plans,” for the display of funded IRC Section 457 plans.)

\* \* \*

**[Completely Superseded]**

**NOTES TO FINANCIAL STATEMENTS**

**SECTION 2300**

Sources: [Add the following:] GASB Statement 2

[Add the following:]

.105v Deferred compensation plans (See Section D25, “Deferred Compensation Plans,” paragraphs .113 and .114.)

\* \* \*

[Add the following:]

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

**SECTION D25**

Source: GASB Statement 2

.101–.108 [GASBS 2, ¶1–¶7 and the last two sentences of ¶8]

.109–.114 [GASBS 2, ¶9–¶14]

.601–.602 [GASBS 2, ¶30 and ¶31]