Preparers of financial statements – and practitioners who perform attest engagements on those statements – often ask questions about how deferred compensation arrangements should be properly reflected in reporting entities’ financial statements.

In most practice situations, the Financial Accounting Standards Board’s Accounting Standards Codification (FASB ASC) Topic 710, Compensation – General, provides the relevant guidance for accounting for these types of arrangements.

The exception would be deferred compensation arrangements that are in substance pension or other postretirement benefit plans. Then the applicable guidance is in FASB ASC 715, Compensation – Retirement Benefits, which will not be covered in this article.

Under the guidance in FASB ASC 710, to the extent the terms of deferred compensation contracts attribute all or a portion of the expected future benefits to:

▶ An individual year of employee service – The cost of those benefits is required to be recognized in that particular year.

▶ A period of service greater than one year – The cost of those benefits is required to be accrued over that period of employee service in a systematic and rational manner.

In circumstances in which arrangements include elements of both current and future services, only the portion applicable to the current services should be accrued.

Some deferred compensation contracts provide for periodic payments to employees or their surviving spouses for life, with provisions for a minimum lump-sum settlement in the event of the early death of one or all of the beneficiaries. The estimated amount of future payments to be made under these types of contracts needs to be accrued over the period of active employment from the time the contract is agreed upon or entered into.

Using the provisions of FASB ASC 710, amounts to be accrued periodically are required to result in an accrued amount at the full-eligibility date equal to the then-present value of all future benefits expected to be paid.

These estimates are required to be based on the life expectancy of each individual concerned (based on the most recent mortality tables available) or on the estimated cost of an annuity contract, rather than on the minimum payable in the event of early death.
It may seem like much ado about nothing, but the truth of the matter is that planning counts.

Being well prepared for your external audit team is critical to ensuring an efficient audit. Beyond providing adequate workspace and access to information and personnel, there is advance groundwork to consider.

Before the audit process even begins, the first concern to be addressed is identifying – and communicating to the audit team – exactly who will be relying on the financial statements and for what purpose.

Is a sale being contemplated? Will the financial statements be used in a business valuation? Perhaps regulatory or credit requirements exist.

Along with potential users come delivery deadlines. It is critical that timelines and expectations be established early and communicated clearly along with the precise nature of the financial statements to be issued.

In circumstances when the scope of the audit will be limited in any way, a detailed discussion must take place. For years ending after Dec. 31, 2012, when auditors believe the scope limitation would result in a disclaimer of opinion, they should not accept the engagement unless certain legal or regulatory exceptions exist.

When non-attest, or “other than audit,” work is to be performed, a clear understanding must be developed for those deliverables.

Whether the accounting firm will be assisting in the preparation of financial statements, supplementary information or tax compliance filings, the nature and responsibility for the work must be established and documented.

Any documents associated with this work should be provided to the auditor because such information is central to the risk assessment and planning process.

In addition, well in advance of the audit, a comprehensive schedule of all checking, savings, money market, investment, transaction, clearing and debt accounts should be compiled, including complete contact information.

Copies of all new debt agreements and banking resolutions should be gathered for the external auditor to facilitate planning. Closing documents for significant assets purchased or disposed of during the audit must also be available.

Have you agreed to purchase or sell a significant asset, or perhaps lease a new vehicle or building?

Even if you have not yet purchased, sold or occupied, the documents are still necessary to support financial statement disclosures. Be sure to pass them along to audit personnel.

The issuance or retirement of stock or agreement to pay off retiring owners comes with documents that should be added to the list, as should settlement agreements with taxing authorities, customers or vendors.

Some of the most often forgotten documents include up-to-date minutes from board and other governance meetings, including annual meetings and related resolutions.

These particular items must be updated throughout the audit process, so be sure to stay on top of communicating to the audit team.

Advance preparation in connection with your annual audit is critical to the process.

A well-prepared organization can improve efficiency and avoid hampering progress or completion.

There are always plenty of items to chase down during audit fieldwork. Complete the gathering process early – well before the audit fieldwork begins.

Most will agree the annual audit process can be a daunting task. With a bit of organization, forward thought and communication, the burden can be greatly reduced. The first step is opening a dialogue with your audit firm.

Documents the auditor needs

For quick reference and quick turnaround in providing data for the audit process, refer to the following list of documents that should be provided to the audit team at the outset:

- Loan documents
- Lease documents
- Documents relating to the purchase or sale of significant assets
- Settlement agreements
- Amortization schedules
- Cash and investment account statements
- Factoring agreements
- Stock books
- Board minutes
- Whistleblower policies
- Employee handbooks and policy and procedure manuals
- Employment contracts
- Benefit plan documents
- Regulatory and compliance documents
- Court decrees and documents regarding pending litigation, commitments or contingencies
- IRS or state taxing authority correspondence
- In short, supply anything that supports what you own, what you owe and what is required for inclusion in your financial statements.
Some retirement plans need an audit: Determining when it’s appropriate

By guest columnist Larisa Rapoport, M.B.A., CPA, with DZH Phillips LLP, a CPAmerica International member firm

How can a retirement plan administrator know that a plan is subject to an audit?
The general rule prescribed by the Department of Labor says a large plan needs to have an audit. A plan is considered “large” if it reaches 100 or more participants at the beginning of the plan year, unless the “80-120 exception” is met.

It’s imperative to understand the two most important concepts to classify a plan properly as “small” or “large”:

★ The number of participants
★ The “80-120 exception” rule

Number of participants

The number of participants at the beginning of the year is entered on Line 5 of Form 5500. According to the instructions to Form 5500, “participants” include all active participants. They are defined as all the employees “who are eligible to elect to have the employer make payments under the Code Section 401(k) qualified cash or deferred arrangement.”

The active participants category includes all of the following:
★ Employees who participate in the plan or have an active account in the plan, including nonvested participants
★ Any eligible employee who is eligible to participate, even if that employee does not make contributions or does not even have an account in a 401(k) plan
★ Employees who have rolled over amounts into the plan but are not yet eligible participants
★ Retired or separated participants, including both retired participants currently receiving benefits and those not yet receiving benefits but haven’t yet rolled over their accounts
★ Deceased participants with one or more beneficiaries who are currently receiving (or entitled to receive) benefits under the plan. The deceased participant is counted as a participant, but the number of beneficiaries receiving benefits attributed to that participant is not.

The active participants category does not include any of the following:
★ Nonvested former employees who have incurred a break in service
★ Former employees who have received a deemed distribution or a cash-out distribution of their entire nonforfeitable accrued benefit

Upon an employee’s departure, termination or retirement, the plan administrator should encourage a speedy rollout of the participant’s account into either the new employer’s plan or the participant’s individual retirement plan account.

The plan administrator should also establish a mandatory cash-out distribution provision in the plan, which would require mandatory cash-out of any participant balance lower than a certain amount – normally $5,000 or less.

The 80-120 exception rule

A Department of Labor regulation was provided to alleviate the filing requirements of a plan with participants numbering close to 100 but continually changing from year to year [DOL Reg. 2520.103-1 (c) and (d)].

It allows plans with between 80 and 120 participants at the beginning of the current year to elect to complete current-year Form 5500 using the same plan category (that is, “small” or “large”) that was used in the previous year.

The following table summarizes the filing provision for plans with 80-120 participants.

<table>
<thead>
<tr>
<th>Participants at start of current year</th>
<th>Requirements followed for the previous-year Form 5500</th>
<th>Requirements to be followed for the current-year Form 5500</th>
</tr>
</thead>
<tbody>
<tr>
<td>80-99</td>
<td>Small plan</td>
<td>Small plan</td>
</tr>
<tr>
<td>80-99</td>
<td>Large plan</td>
<td>May elect to file Form 5500 as a large plan or switch to a small plan</td>
</tr>
<tr>
<td>100-120</td>
<td>Small plan</td>
<td>May elect to file Form 5500 as a small plan again or switch to a large plan</td>
</tr>
<tr>
<td>100-120</td>
<td>Large plan</td>
<td>Large plan</td>
</tr>
<tr>
<td>Over 120</td>
<td>Large plan</td>
<td>Large plan</td>
</tr>
<tr>
<td>Over 120</td>
<td>Small plan</td>
<td>Large plan</td>
</tr>
</tbody>
</table>

If a plan has 105 participants at the beginning of the year and was classified as a small plan in the previous year, it can elect to file as a small plan once again. However, when the number of participants reaches 120, the plan must be classified as large and must have an audit.

If a plan has 95 participants at the beginning of the year and was classified as a large plan last year, it may elect to switch to a small plan.

To avoid the audit requirement, a plan with participants numbering below 120, which had filed as a small plan in the previous year, normally would elect to remain a small plan – as opposed to switching to a large plan. Therefore, a 100-participants rule is largely seen as a 120-participants rule.

Once the participant number of 120 is reached, the plan must be classified as a large plan. A plan classified as a large plan cannot go back to classification as a small plan, unless the number of participants falls below 100 participants.

Plan administrators should be aware of these rules to ensure their plan reports the number of participants properly, and if the audit requirement is met, the audit is conducted on time. Penalties for not conducting the audit, when required, can be severe.
At the end of the accrual period, the aggregate amount accrued needs to equal the then-present value of the benefits expected to be provided to the employee, any beneficiaries and covered dependents in exchange for the employee service to that date.

In an effort to put some debits and credits around a hypothetical example often noticed in practice, assume that Richards Corporation, the reporting entity, enters into a deferred compensation contract with its president, Susanne Richards. The terms of the arrangement clearly stipulate that the reporting entity will pay the president a lump sum equal to twice her annual salary on the date of her mandatory retirement, which is five years in the future.

Her current salary is $150,000. Twice that salary would result in a deferred compensation expense of $300,000 that should be attributed to the five remaining service years.

The reporting entity would make the following entry each year under the lump-sum payment agreement, which is based on a lump-sum payment in the amount of $300,000:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Compensation Expense</td>
<td>$60,000</td>
</tr>
<tr>
<td>Deferred Compensation Liability</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

Now suppose that, during the attribution period, the president receives a pay raise that increases the amount of the lump-sum payment she is entitled to receive. The amount expensed in each reporting period would need to increase prospectively to take into account the catch-up adjustment necessary to reflect the actual lump-sum payment that the president would receive at retirement.

Assuming that there was no increase in pay for the president during the five years of remaining service, the entry to record the lump-sum payment would be as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deferred Compensation Liability</td>
<td>$300,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

The two entries illustrated above are based on a choice by the reporting entity not to discount the estimated amount of the future liability.

The reporting entity made this choice to comply with the FASB ASC 710 requirement that amounts accrued not be less than the present value of the estimated payments that will be made. Essentially, while it would have been acceptable to record amounts using present value calculations, the election was made not to use that option.

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