Statement of Financial Accounting Standards No. 146

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Accounting for Costs Associated with Exit or Disposal Activities

June 2002

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Accounting for Costs Associated with Exit or Disposal Activities

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FAS 146: Accounting for Costs Associated with Exit or Disposal Activities

FAS 146 Summary

This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)."

Reasons for Issuing This Statement

The Board decided to address the accounting and reporting for costs associated with exit or disposal activities because entities increasingly are engaging in exit and disposal activities and certain costs associated with those activities were recognized as liabilities at a plan (commitment) date under Issue 94-3 that did not meet the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

Differences between This Statement and Issue 94-3

The principal difference between this Statement and Issue 94-3 relates to its requirements for recognition of a liability for a cost associated with an exit or disposal activity. This Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost as defined in Issue 94-3 was recognized at the date of an entity's commitment to an exit plan. A fundamental conclusion reached by the Board in this Statement is that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, this Statement eliminates the definition and requirements for recognition of exit costs in Issue 94-3. This Statement also establishes that fair value is the objective for initial measurement of the liability.

How the Changes in This Statement Improve Financial Reporting

This Statement improves financial reporting by requiring that a liability for a cost associated

with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. The accounting for similar events and circumstances will be the same, thereby improving the comparability and representational faithfulness of reported financial information.

How the Conclusions in This Statement Relate to the Conceptual Framework

This Statement specifies that a liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability in Concepts Statement 6 is met.

This Statement affirms the Board's view that a fair value measurement is the most relevant and faithful representation of the underlying economics of a transaction. As discussed in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* fair value is the objective for initial measurements that are developed using present value techniques.

This Statement considers the qualitative characteristics discussed in FASB Concepts Statement No. 2*, Qualitative Characteristics of Accounting Information,* specifically, that providing comparable financial information enables investors, creditors, and other users of financial statements to identify similarities in and differences between two sets of economic events. Ultimately, that financial information facilitates their investment, credit, and other resource allocation decisions and contributes to the efficient functioning of the capital markets.

The Effective Date of This Statement

The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged.

INTRODUCTION

1. This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." Appendix A provides additional guidance on the application of certain provisions of this Statement and is an integral part of the standards provided in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

2. This Statement applies to costs associated with an *exit activity* [1] that does not involve an entity newly acquired in a business combination [2] or with a disposal activity covered by FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* [3] Those costs include, but are not limited to, the following:

a. Termination benefits provided to current employees that are involuntarily terminated under the terms of a benefit arrangement that, in substance, is not an ongoing benefit arrangement or an individual deferred compensation contract (hereinafter referred to as *one-time termination benefits*) [4]
b. Costs to terminate a contract that is not a capital lease [5]
c. Costs to consolidate facilities or relocate employees.

This Statement does not apply to costs associated with the retirement of a long-lived asset covered by FASB Statement No. 143, *Accounting for Asset Retirement Obligations.*

Recognition and Measurement

3. A liability for a cost associated with an exit or disposal activity shall be recognized and measured initially at its fair value in the period in which the liability is incurred, except as indicated in paragraph 11 (for a liability for one-time termination benefits that is incurred over time). In the unusual circumstance in which fair value cannot be reasonably estimated, the liability shall be recognized initially in the period in which fair value can be reasonably estimated.

4. A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability is met. Paragraph 35 of FASB Concepts Statement No. 6, *Elements of Financial Statements,* defines liabilities as follows:

> Liabilities are probable [21] future sacrifices of economic benefits arising from present obligations [22] of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
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> [21]*Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary,* p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44-48).
>
> [22]*Obligations* in the definition is broader than *legal obligations*. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (*Webster's New World Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37-40).

Only present obligations to others are liabilities under the definition. An obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. An exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability.

5. The fair value of a liability is the amount at which that liability could be settled in a current transaction between willing parties, that is, other than in a forced or liquidation transaction. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances, including prices for similar liabilities and the results of using other valuation techniques. (Certain valuation techniques are discussed in Appendix A.)

6. In periods subsequent to initial measurement, changes to the liability shall be measured using the credit-adjusted risk-free rate that was used to measure the liability initially. The cumulative effect of a change resulting from a revision to either the timing or the amount of estimated cash flows shall be recognized as an adjustment to the liability in the period of the change and reported in the same line item(s) in the income statement (statement of activities) used when the related costs were recognized initially. Changes due to the passage of time shall be recognized as an increase in the carrying amount of the liability and as an expense (for example, accretion expense). [6]

Recognition and Measurement of Certain Costs

7. Paragraphs 8–17 provide additional guidance for applying the recognition and measurement provisions of this Statement to certain costs that often are associated with an exit or disposal activity.

One-Time Termination Benefits

8. As indicated in paragraph 2(a), one-time termination benefits are benefits provided to current employees that are involuntarily terminated under the terms of a one-time benefit arrangement. A one-time benefit arrangement is an arrangement established by a plan of termination that applies for a specified termination event or for a specified future period. [7] A one-time benefit arrangement exists at the date the plan of termination meets all of the following criteria and has been communicated to employees (hereinafter referred to as the *communication date*):

a. Management, having the authority to approve the action, commits to a plan of termination.
b. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.

c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.
d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

9. The timing of recognition and related measurement of a liability for one-time termination benefits depends on whether employees are required to render service until they are terminated in order to receive the termination benefits and, if so, whether employees will be retained to render service beyond a minimum retention period. The minimum retention period shall not exceed the *legal notification period,* [8] or in the absence of a legal notification requirement, 60 days.

10. If employees are not required to render service until they are terminated in order to receive the termination benefits (that is, if employees are entitled to receive the termination benefits regardless of when they leave) or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be recognized and measured at its fair value at the communication date. The provisions of paragraph 6 shall apply in periods subsequent to the communication date. (Example 1 of Appendix A illustrates that situation.)

11. If employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date. The liability shall be recognized ratably over the future service period. A change resulting from a revision to either the timing or the amount of estimated cash flows over the future service period shall be measured using the credit-adjusted risk-free rate that was used to measure the liability initially. The cumulative effect of the change shall be recognized as an adjustment to the liability in the period of the change. The provisions of paragraph 6 shall apply in periods subsequent to the termination date. (Example 2 of Appendix A illustrates that situation.)

12. If a plan of termination changes and employees that were expected to be terminated within the minimum retention period are retained to render service beyond that period, a liability previously recognized at the communication date shall be adjusted to the amount that would have been recognized if the provisions of paragraph 11 had been applied in all periods subsequent to the communication date. The cumulative effect of the change shall be recognized as an adjustment to the liability in the period of the change. The provisions of paragraph 11 shall apply in subsequent periods.

13. If a plan of termination that meets the criteria in paragraph 8 includes both involuntary termination benefits and termination benefits offered for a short period of time in exchange for

employees' voluntary termination of service, a liability for the involuntary termination benefits shall be recognized in accordance with this Statement. A liability for the incremental voluntary termination benefits (the excess of the voluntary termination benefit amount over the involuntary termination benefit amount) shall be recognized in accordance with FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*. [9] (Example 3 of Appendix A illustrates that situation.)

Contract Termination Costs

14. For purposes of this Statement, costs to terminate an operating lease or other contract are (a) costs to terminate the contract before the end of its term or (b) costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity.

15. A liability for costs to terminate a contract before the end of its term shall be recognized and measured at its fair value when the entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty). The provisions of paragraph 6 shall apply in periods subsequent to that date.

16. A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be recognized and measured at its fair value when the entity ceases using the right conveyed by the contract, for example, the right to use a leased property or to receive future goods or services (hereinafter referred to as the *cease-use date*). [10] If the contract is an operating lease, the fair value of the liability at the cease-use date shall be determined based on the remaining lease rentals, [11] reduced by estimated sublease rentals that could be reasonably obtained for the property, even if the entity does not intend to enter into a sublease. Remaining lease rentals shall not be reduced to an amount less than zero. The provisions of paragraph 6 shall apply in periods subsequent to the cease-use date. (Example 4 of Appendix A illustrates that situation.)

Other Associated Costs

17. Other costs associated with an exit or disposal activity include, but are not limited to, costs to consolidate or close facilities and relocate employees. A liability for other costs associated with an exit or disposal activity shall be recognized and measured at its fair value in the period in which the liability is incurred (generally, when goods or services associated with the activity are received). The liability shall not be recognized before it is incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of a plan.

Reporting

18. Costs associated with an exit or disposal activity that does not involve a discontinued operation shall be included in income from continuing operations before income taxes in the income statement of a business enterprise and in income from continuing operations in the

statement of activities of a not-for-profit organization. If a subtotal such as "income from operations" is presented, it shall include the amounts of those costs. Costs associated with an exit or disposal activity that involves a discontinued operation shall be included in the results of discontinued operations. [12]

19. If an event or circumstance occurs that discharges or removes an entity's responsibility to settle a liability for a cost associated with an exit or disposal activity recognized in a prior period, the liability shall be reversed. The related costs shall be reversed through the same line item(s) in the income statement (statement of activities) used when those costs were recognized initially.

Disclosure

20. The following information shall be disclosed in notes to financial statements that include the period in which an exit or disposal activity is initiated (refer to paragraph 21) and any subsequent period until the activity is completed:

a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date
b. For each major type of cost associated with the activity (for example, one-time termination benefits, contract termination costs, and other associated costs):
   (1) The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date
   (2) A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) therefor
c. The line item(s) in the income statement or the statement of activities in which the costs in (b) above are aggregated
d. For each reportable segment, the total amount of costs expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date, net of any adjustments to the liability with an explanation of the reason(s) therefor
e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons therefor.

Effective Date and Transition

21. The provisions of this Statement shall be effective for exit or disposal activities initiated after December 31, 2002. Early application is encouraged. Previously issued financial statements shall not be restated. For purposes of this Statement, an exit or disposal activity is initiated when management, having the authority to approve the action, commits to an exit or disposal plan or otherwise disposes of a long-lived asset (disposal group) and, if the activity

involves the termination of employees, the criteria for a plan of termination in paragraph 8 of this Statement are met. The provisions of Issue 94-3 shall continue to apply for an exit activity initiated under an exit plan that met the criteria of Issue 94-3 prior to this Statement's initial application.

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

This Statement was adopted by the affirmative votes of six members of the Financial Accounting Standards Board. Mr. Foster dissented.

Mr. Foster dissents from the issuance of this Statement because he disagrees with the Board's conclusions on (1) subsequent measurement of liabilities for property leased under operating leases that will not be used in future operations, (2) permitting the time value of money to be ignored in measuring liabilities for one-time termination benefits that are granted in the form of an enhancement to an existing postemployment benefit plan for which obligations are not recognized by the employer on a discounted basis, as permitted by FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits,* and (3) using the employee benefits model to account for one-time termination benefits.

The cash flows used in measuring liabilities for leases of property that will not be used in future operations must be reassessed each period for market changes in lease rates. Consequently, when there is a change in the expected cash flows, the new carrying amount is unrelated to previous amounts and accounting conventions and is a fresh-start measurement as that term is defined in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. In that Concepts Statement, the Board concluded that the only objective of using present value, when used in accounting measurements at initial recognition and fresh-start measurements, is to estimate fair value. Mr. Foster believes the Board should adhere to its conceptual framework and require that the objective of subsequent measurements of liabilities for leases of property that will not be used in future operations, which are fresh-start measurements, be fair value. He observes that the difference between measuring such liabilities at fair value and the method adopted by the Board is solely which interest rate is used to discount the estimated cash flows. Furthermore, the current risk-free rate is always easily observable. Thus, there are no incremental costs involved in estimating fair value, and Mr. Foster believes fair value is clearly a more relevant measurement of the liability than that resulting from the method required by this Statement.

This Statement does not amend Statement 112 to require that all one-time termination benefits that are granted in the form of enhancements to existing postemployment benefit plans be accounted for in accordance with the requirements for other one-time termination benefits under this Statement—specifically, that liabilities for those termination benefits be discounted, consistent with Concepts Statement 7. Mr. Foster believes there is trivial effort involved in discounting liabilities for the time value of money and that the benefits to users of financial statements of doing so are significant.

While Mr. Foster acknowledges that paragraph 207 of Concepts Statement 6 sanctions the employee service model, he believes that the requirement of this Statement that liabilities should be recognized initially when incurred is a more appropriate method for accounting for one-time termination benefits. He prefers the approach described in paragraph B33 that would delay recognition of a liability for those termination benefits until the entity has little or no discretion to avoid a transfer of assets—the termination date. He notes that the entity has discretion to avoid payment of the termination benefits at all times during the period in which an employee is to render service by not terminating the employee. It is only when the employee is terminated that the employee becomes entitled to receive the termination benefits, and termination is the event that causes the obligation to become a present obligation.

Members of the Financial Accounting Standards Board:

Edmund L. Jenkins, *Chairman*
G. Michael Crooch
John M. Foster
Gary S. Schieneman
Katherine Schipper
Edward W. Trott
John K. Wulff

Appendix A: IMPLEMENTATION GUIDANCE

Introduction

A1. This appendix describes certain provisions of this Statement in more detail. This appendix also provides examples that incorporate simplified assumptions to illustrate how certain provisions of this Statement apply in certain specific situations. The examples do not address all possible situations or applications of this Statement. This appendix is an integral part of the standards provided in this Statement.

Fair Value

A2. The objective of initial measurement of a liability for a cost associated with an exit or disposal activity is fair value (paragraph 3). For a liability, fair value represents the amount that a willing third party of comparable credit standing would demand and could expect to receive to assume all of the duties, uncertainties, and risks inherent in the transferor's obligation, including a profit element or risk premium. [13]

A3. Quoted market prices are the best representation of fair value. However, for many of the liabilities covered by this Statement, quoted market prices will not be available. Consequently, in those circumstances fair value will be estimated using some other valuation technique.

A4. A present value technique often is the best available valuation technique with which to estimate the fair value of a liability. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* discusses two present value techniques. [14] The first technique is expected present value, in which multiple cash flow scenarios that reflect the range of possible outcomes and a risk-free rate adjusted for the entity's credit standing [15] are used to estimate fair value. The second technique is traditional present value, in which a single set of estimated cash flows and a single risk-adjusted interest rate are used to estimate fair value. In contrast to a traditional present value technique, which incorporates uncertainty in the amount and timing of cash flows in the interest rate, an expected present value technique incorporates that uncertainty in the estimated cash flows. Thus, an expected present value technique often will be the appropriate valuation technique if a liability for a cost associated with an exit or disposal activity has uncertainties in both the amount and timing of estimated cash flows.

A5. When using a present value technique, estimates of future cash flows should incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. Otherwise, an entity may use its own estimates of future cash flows. [16]

A6. In some situations, a fair value measurement for a liability associated with an exit or disposal activity obtained using a valuation technique other than a present value technique may not be materially different from a fair value measurement obtained using a present value technique. In those situations, this Statement does not preclude the use of estimates and computational shortcuts that are consistent with a fair value measurement objective.

Examples 1–3—One-Time Termination Benefits

A7. Examples 1–3 illustrate the application of the recognition and measurement provisions of this Statement to one-time termination benefits. Each example assumes that an entity has a one-time benefit arrangement established by a plan of termination that meets the criteria of paragraph 8 and has been communicated to employees.

Example 1

A8. An entity plans to cease operations in a particular location and determines that it no longer needs the 100 employees that currently work in that location. The entity notifies the employees that they will be terminated in 90 days. Each employee will receive as a termination benefit a cash payment of $6,000, which will be paid at the date an employee ceases rendering service during the 90-day period. In accordance with paragraph 10, a liability would be recognized at the communication date and measured at its fair value. In this case, because of the short discount period, $600,000 may not be materially different from the fair value of the liability at the communication date.

Example 2

A9. An entity plans to shut down a manufacturing facility in 16 months and, at that time, terminate all of the remaining employees at the facility. To induce employees to stay until the facility is shut down, the entity establishes a one-time stay bonus arrangement. Each employee that stays and renders service for the full 16-month period will receive as a termination benefit a cash payment of $10,000, which will be paid 6 months after the termination date. An employee that leaves voluntarily before the facility is shut down will not be entitled to receive any portion of the termination benefit. In accordance with paragraph 11, a liability for the termination benefits would be measured initially at the communication date based on the fair value of the liability as of the termination date and recognized ratably over the future service period (as illustrated in (a) below). The fair value of the liability as of the termination date would be adjusted cumulatively for changes resulting from revisions to estimated cash flows over the future service period, measured using the credit-adjusted risk-free rate that was used to measure the liability initially (as illustrated in (b) below).

a. The fair value of the liability as of the termination date is $962,240, estimated at the communication date using an expected present value technique. The expected cash flows of $1 million (to be paid 6 months after the termination date), which consider the likelihood that some employees will leave voluntarily before the facility is shut down, are discounted for 6 months at the credit-adjusted risk-free rate of 8 percent. [17] Thus, a liability of $60,140 would be recognized in each month during the future service period (16 months).
b. After eight months, more employees than originally estimated leave voluntarily. The entity adjusts the fair value of the liability as of the termination date to $769,792 to reflect the revised expected cash flows of $800,000 (to be paid 6 months after the termination date), discounted for 6 months at the credit-adjusted risk-free rate that was used to measure the liability initially (8 percent). Based on that revised estimate, a liability (expense) of $48,112 would have been recognized in each month during the future service period. Thus, the liability recognized to date of $481,120 ($60,140 × 8) would be reduced to $384,896 ($48,112 × 8) to reflect the cumulative effect of that change (of $96,224). A liability of $48,112 would be recognized in each month during the remaining future service period (8 months). Accretion expense would be recognized after the termination date in accordance with paragraph 6.

Example 3

A10. An entity initiates changes to streamline operations in a particular location and determines that, as a result, it no longer needs 100 of the employees that currently work in that location. The plan of termination provides for both voluntary and involuntary termination benefits (in the form of cash payments). Specifically, the entity offers each employee (up to 100 employees) that voluntarily terminates within 30 days a voluntary termination benefit of $10,000 to be paid at the separation date. Each employee that is involuntarily terminated thereafter (to reach the target of 100) will receive an involuntary termination benefit of $6,000 to be paid at the termination date. The entity expects all 100 employees to leave (voluntarily or involuntarily) within the minimum retention period. In accordance with paragraphs 9 and 10, a liability for the involuntary termination benefit (of $6,000 per employee) would be recognized at the communication date and measured at its fair value. In this case, because of the short discount period, $600,000 may not be materially different from the fair value of the liability at the communication date. As noted in paragraph 13, a liability for the incremental voluntary termination benefit (of $4,000 per employee) would be recognized in accordance with FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (that is, when employees accept the offer).

Example 4—Costs to Terminate an Operating Lease

A11. An entity leases a facility under an operating lease that requires the entity to pay lease rentals of $100,000 per year for 10 years. After using the facility for five years, the entity commits to an exit plan. In connection with that plan, the entity will cease using the facility in 1 year (after using the facility for 6 years), at which time the remaining lease rentals will be $400,000 ($100,000 per year for the remaining term of 4 years). In accordance with paragraph 16, a liability for the remaining lease rentals, reduced by actual (or estimated) sublease rentals, would be recognized and measured at its fair value at the cease-use date (as illustrated in (a) below). In accordance with paragraph 6, the liability would be adjusted for changes, if any, resulting from revisions to estimated cash flows after the cease-use date, measured using the credit-adjusted risk-free rate that was used to measure the liability initially (as illustrated in (b) below).

a. Based on market rentals for similar leased property, the entity determines that if it desired, it could sublease the facility and receive sublease rentals of $300,000 ($75,000 per year for the remaining lease term of 4 years). However, for competitive reasons, the entity decides not to sublease the facility (or otherwise terminate the lease) at the cease-use date. The fair value of the liability at the cease-use date is $89,427, estimated using an expected present value technique. The expected net cash flows of $100,000 ($25,000 per year for the remaining lease term of 4 years) are discounted using a credit-adjusted risk-free rate of 8 percent. [18] Thus, a liability (expense) of $89,427 would be recognized at the cease-use date. Accretion expense would be recognized after the cease-use date in accordance with paragraph 6. (The entity will recognize the impact of deciding not to sublease the property over the period the property is not subleased. For example, in the first year after the cease-use date, an expense of $75,000 would be recognized as the impact of not subleasing the property, which reflects the annual lease payment of $100,000 net of the liability extinguishment of $25,000).
b. At the end of one year, the competitive factors referred to above are no longer present. The entity decides to sublease the facility and enters into a sublease. The entity will receive sublease rentals of $250,000 ($83,333 per year for the remaining lease term of 3 years), negotiated based on market rentals for similar leased property at the sublease date. The entity adjusts the carrying amount of the liability at the sublease date to $46,388 to reflect the revised expected net cash flows of $50,000 ($16,667 per year for the remaining lease term of 3 years), which are discounted at the credit-adjusted risk-free rate that was used to

measure the liability initially (8 percent). Accretion expense would be recognized after the sublease date in accordance with paragraph 6.

Appendix B

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

CONTENTS

Paragraph Numbers

Appendix B: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

B1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes the reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

B2. APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions,* was issued in 1973. Opinion 30 addressed the accounting for the operations of a *segment of a business* to be disposed of, as previously defined in that Opinion. Under Opinion 30, a segment of a business to be disposed of was measured at the lower of its carrying amount or net realizable value, adjusted for expected future operating losses and costs associated with the disposal, at a plan (measurement) date. If a loss on disposal was expected, those items (expected future operating losses and costs associated with the disposal) were recognized (as liabilities) as part of the loss at that date so that they would not affect earnings reported in future periods. [19]

B3. The definition of a liability subsequently set forth in FASB Concepts Statement No. 6, *Elements of Financial Statements* (paragraph 35), incorporates the view that assets and liabilities are the fundamental elements of financial statements. An essential characteristic of that definition is that a liability is a present obligation to others. In its discussions leading to this Statement, the Board observed that because a plan merely reflects an entity's intended actions, it does not, by itself, create a present obligation to others for the costs expected to be incurred under the plan. Thus, some costs were recognized as liabilities at a plan (measurement) date under Opinion 30 that did not meet the definition of a liability.

B4. FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of,* was issued in 1995. Among other things, Statement 121 addressed the accounting for long-lived assets to be disposed of that were not covered by Opinion 30. Under Statement 121, a long-lived asset to be disposed of was measured at the lower of its carrying amount or fair value less cost to sell, which excludes expected future operating losses and costs associated with the disposal that marketplace participants would not similarly consider in their estimates of fair value less cost to sell. However, Statement 121 did not address the accounting for expected future operating losses or recognition of liabilities for other costs. Instead, Statement 121 referred to the guidance in EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)."

B5. Issue 94-3, which was completed in 1995, addressed the recognition of liabilities for costs associated with an exit activity not covered by Opinion 30. Under Issue 94-3, only costs that met its definition of exit costs were recognized as liabilities at a plan (commitment) date. The definition of exit costs in Issue 94-3 excluded expected future operating losses. However, in its discussions leading to this Statement, the Board observed that because Issue 94-3 retained the plan date notion in Opinion 30, some costs continued to be recognized as liabilities at a plan (commitment) date under Issue 94-3 that did not meet the definition of a liability.

B6. In August 1996, the Board added to its agenda a project related to Statement 121. The principal objectives of that project were to address (a) differences in the accounting for long-lived assets and operations (segments) to be disposed of under Statement 121 and Opinion 30 and (b) the accounting for costs associated with asset disposal activities and other similar activities, including exit activities under Issue 94-3.

B7. In June 2000, the Board issued an Exposure Draft, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*. The Board received comment letters from 53 respondents to the Exposure Draft. In January 2001, the Board held a public roundtable meeting with some of those respondents to discuss significant issues raised in the comment letters. During its redeliberations of those issues, the Board decided to complete the project in two phases to avoid delaying the issuance of guidance on the accounting for long-lived assets and operations to be disposed of.

B8. The first phase of the project was completed in August 2001 with the issuance of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Statement 144 establishes an accounting model based on the framework in Statement 121 for long-lived assets and disposal groups to be disposed of, including operations (components of an entity), and supersedes Statement 121 in its entirety and Opinion 30 as it relates to operations (segments) to be disposed of.

B9. This Statement represents the second and final phase of the project. It establishes an accounting model based on the FASB's conceptual framework for recognition and measurement of a liability for a cost associated with an exit or disposal activity and nullifies Issue 94-3. The fundamental conclusion reached by the Board in developing that accounting model is that a liability for a cost associated with an exit or disposal activity should be recognized and measured initially at its fair value when it is incurred. A liability is incurred when the definition of a liability in paragraph 35 of Concepts Statement 6 is met.

Basis for Conclusions

Scope

B10. This Statement applies to costs associated with an exit activity or with a disposal activity covered by Statement 144. As indicated in paragraph 2, costs excluded from the scope of this Statement include costs associated with an exit activity that involves an entity newly acquired in a business combination (which the Board is reconsidering in its project on business combinations—purchase method procedures), termination benefits provided to employees that are involuntarily or voluntarily terminated covered by the other accounting pronouncements listed in footnote 4 to paragraph 2, and costs to terminate a capital lease. The Board concluded that the objectives of this project could be achieved without reconsidering the accounting for those costs in this Statement.

B11. The Exposure Draft proposed to exclude costs to terminate a contract other than an operating lease. At that time, the Board concluded that addressing all contract termination costs included in the scope of Issue 94-3 could require it to address issues on the accounting for other executory contracts that are beyond the scope of this Statement. For that reason, the Board initially decided that the guidance in Issue 94-3 should continue to apply for those contract termination costs. However, some respondents to the Exposure Draft said that allowing the guidance in Issue 94-3 to continue to apply only for those contract termination costs would be confusing. The Board subsequently decided to reconsider the guidance in Issue 94-3 in its entirety and include in the scope of this Statement the contract termination costs previously included in the scope of Issue 94-3.

Recognition and Measurement

B12. During its deliberations leading to the Exposure Draft, the Board decided that the requirements of this Statement for recognition of a liability for a cost associated with an exit or disposal activity should incorporate the guidance in FASB Statement No. 5, *Accounting for Contingencies*. Accordingly, the Exposure Draft would have required that the liability be recognized initially when the likelihood of future settlement is probable, as that term is used in Statement 5, [20] and the amount can be reasonably estimated—the transaction or other event obligating the entity having occurred previously. The Board also decided that fair value should be the objective for initial measurement of the liability.

Fair Value

B13. During its redeliberations of the Exposure Draft, the Board affirmed that fair value is the objective for initial measurement of a liability for a cost associated with an exit or disposal activity. The Board believes that fair value is the most relevant and faithful representation of the underlying economics of a transaction—it is basic to economic theory and is grounded in the reality of the marketplace. FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* establishes fair value as the objective for both initial measurements and fresh-start measurements in subsequent periods that are developed using present value techniques. Accordingly, the Board considered whether to require a fresh-start approach for subsequent measurements of a liability for a cost associated with an exit or disposal activity covered by this Statement or to limit the fair value objective to initial measurement. [21]

B14. The Board agreed that, conceptually, subsequent measurements of the liabilities covered by this Statement are fresh-start measurements that should be measured at fair value. For some of those liabilities, in particular, liabilities related to a leased property under an operating lease that will not be used in future operations, measurements are based on estimates that are revised to incorporate current information as new facts and circumstances become known. Moreover, most of those liabilities often will be settled in cash, similar to financial instruments, which the Board believes should be measured at fair value.

B15. However, the Board decided, as it did in FASB Statement No. 143, *Accounting for Asset Retirement Obligations,* not to require a fresh-start approach for the liabilities covered by this Statement. The Board concluded that until issues related to determining the fair values of financial instruments are resolved and fair value is required for subsequent measurement of more (or all) liabilities, it would be premature to require that type of ongoing measurement in this Statement. [22] Instead, the Board decided to require an approach that holds interest rates constant, thereby measuring changes, if any, resulting from revisions to either the timing or the amount of estimated cash flows using the credit-adjusted risk-free rate that was used to measure the liability initially.

Statement 5 Probability Criterion

B16. In view of its decision that fair value is the objective for initial measurement of a liability for a cost associated with an exit or disposal activity, the Board reconsidered its decision that the recognition requirements of this Statement should incorporate the guidance in Statement 5. The Board subsequently concluded, as it did in Statement 143, that because Statement 5 and Concepts Statement 7 deal with uncertainty differently, the recognition guidance in Statement 5 is inconsistent with an objective of measuring fair value. Statement 5 deals with uncertainty by requiring a probability threshold for *recognition* of a loss contingency. Concepts Statement 7 deals with uncertainty in the amount and timing of the future cash flows necessary to settle a liability by requiring that the likelihood of possible outcomes be incorporated into the *measurement* of the fair value of the liability. [23]

B17. To resolve that inconsistency, the Board decided that a liability for a cost associated with an exit or disposal activity should be recognized initially when the liability is incurred. Thus, in determining whether to recognize a liability for a cost associated with an exit or disposal activity, and in measuring its fair value, the guidance in Statement 5 and FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* does not apply.

Definition and Essential Characteristics of a Liability

B18. This Statement specifies that a liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability is met. Paragraph 35 of Concepts Statement 6 states:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Footnote references omitted.]

Paragraph 36 of Concepts Statement 6 identifies three essential characteristics of a liability, all of which must be present to meet the definition of a liability. In this Statement, the Board clarifies those essential characteristics of a liability as they apply to a cost associated with an exit or disposal activity covered by this Statement.

B19. The first essential characteristic of a liability is that an entity has "a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand." In general, an obligation is created by an entity's promise, on which others are justified in relying, to take a particular course of action (perform) that will entail the future transfer or use of assets. In that context:

a. An entity's promise may be (1) unconditional or conditional upon the occurrence of a specified future event that is or is not within the entity's control, (2) stated in words, either oral or written, or (3) inferred from the entity's past practice, which, absent evidence to the contrary, others can presume that the entity will continue.
b. Others are justified in relying on an entity's promise if (1) they, or their representatives, are the recipients of the promise, (2) they can reasonably expect the entity to perform (that is, the promise is credible), and (3) they either will benefit from the entity's performance or will suffer loss or harm from the entity's nonperformance.

B20. The second essential characteristic of a liability is that ". . . the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice." Paragraph 203 of Concepts Statement 6 elaborates on that characteristic, stating that an entity is not obligated to others if it can avoid the future transfer or use of assets at its discretion without significant penalty.

B21. The third essential characteristic of a liability is that ". . . the transaction or other event obligating the entity has already happened." Paragraph 206 of Concepts Statement 6 states:

> The definition of liabilities in paragraph 35 distinguishes between present and

> future obligations of an entity. Only present obligations are liabilities under the definition, and they are liabilities of a particular entity as a result of the occurrence of transactions or other events or circumstances affecting the entity.

The Board concluded that because an exit or disposal plan merely reflects an entity's intended actions and, by itself, does not create a present obligation to others for the costs expected to be incurred under the plan, an entity's commitment to such a plan, by itself, is not the requisite past transaction or event for recognition of a liability. [24]

B22. The Board acknowledges that identifying the requisite past transaction or event for recognition of a liability requires judgment, especially in situations that involve a series of transactions or other events or circumstances affecting the entity over time. The Board decided that this Statement should provide additional guidance for applying its recognition and measurement provisions to certain costs that often are associated with an exit or disposal activity. That additional guidance focuses principally on one-time termination benefits and contract termination costs.

One-Time Termination Benefits

B23. This Statement applies to one-time termination benefits provided to current employees that are involuntarily terminated under the terms of a one-time benefit arrangement, that is, a benefit arrangement established by a plan of termination that applies for a specified termination event or for a specified future period. A one-time benefit arrangement exists at the date the plan of termination meets all of the criteria in paragraph 8 and has been communicated to employees. This Statement refers to that date as the *communication date*. The Board concluded that an entity's communication of a promise to provide one-time termination benefits is a promise that, as discussed in paragraph B19, creates an obligation at the communication date to provide the termination benefits if employees are terminated.

Future service requirement

B24. During its deliberations leading to the Exposure Draft, the Board decided that the recognition approach for an obligation to provide one-time termination benefits should be based on whether the benefit arrangement requires employees to render future service and, in substance, is a "stay bonus" arrangement, as discussed in Issue 94-3.

B25. Under Issue 94-3, the determination of whether employees were required to render future service was based on facts and circumstances that, while largely unspecified, included the benefit formula used to calculate an employee's termination benefit. Issue 94-3 stated that ". . . facts and circumstances would have to be evaluated to determine if, in substance, all or some portion of those benefits should be accounted for prospectively as payments for future services rather than recognized currently as benefits for termination." The Board concluded that because a one-time benefit arrangement does not exist until a plan of termination meets all of the criteria in paragraph 8 and has been communicated to employees, a benefit formula should not be used as a basis for determining whether the future services of employees are required (as discussed in paragraph B28). Also, the Board observed that numerous facts and circumstances affect an entity's decision to provide termination benefits and that the judgment applied in assessing those facts and circumstances is necessarily subjective. Largely for those reasons, the Board concluded that the facts-and-circumstances approach in Issue 94-3 could result in differences in accounting for one-time termination benefits that are substantively identical.

B26. The Board decided that the determination of whether employees are required to render future service should be based on when employees are entitled to receive the termination benefits, without regard to other facts and circumstances. In reaching that decision, the Board reasoned that an entity would not communicate a promise to provide one-time termination benefits in advance of termination unless the entity had a need for employees to render future service. Thus, the Exposure Draft specified that employees are required to render future service if they are not entitled to receive the termination benefits until they are terminated. The Board decided that if employees are required to render future service until they are terminated in order to receive the termination benefits, a liability for the termination benefits should be recognized over the future service period. Otherwise, a liability for the termination benefits should be recognized at the communication date.

B27. Several respondents to the Exposure Draft disagreed with that approach. They said that there may be valid reasons, other than the need for employees to render future service, for communicating a promise to provide one-time termination benefits in advance of termination. Some respondents said that the termination benefits are "rewards" for past service, that is, service rendered prior to the communication date, especially when the benefit formula used to calculate an employee's termination benefit is based on length of service. Other respondents said that an entity may be legally obligated to notify employees of a termination decision in advance or, for some other reason, may decide to provide a transition period for employees that are to be terminated. A few respondents said that even if there is a need for employees to render future service, for example, to wind down operations, the future service period often is relatively short. Respondents indicated that in those situations, a requirement to recognize a liability for the termination benefits over the future service period would, among other things, result in "excessive" compensation expense during that period.

B28. During its redeliberations of the Exposure Draft, the Board acknowledged that in some situations, the benefit formula used to calculate an employee's termination benefit may attribute some (or all) of the termination benefits to past service. However, as previously noted (in paragraph B25), the Board concluded that in those situations, the benefit formula, in and of itself, does not render one-time termination benefits a "reward" for past service. The Board observed that an objective of providing a "reward" for past service could be accomplished by granting immediately vested benefits. In that case, the benefit arrangement could be structured so that employees are entitled to receive the termination benefits regardless of whether they choose to render future service.

B29. The Board acknowledged that an entity may communicate a promise to provide one-time termination benefits in advance of termination for reasons other than the need for employees to render future service, including the need to identify and notify individual employees that are to be terminated and to provide a transition period for those employees, which also may be required by law. For example, in the United States, the Worker Adjustment and Retraining Notification Act (WARN) requires entities with 100 or more employees to notify employees 60 days in advance of covered plant closings and mass layoffs, except as specified. Similar advance notification requirements exist in countries outside the United States but vary with respect to the requisite notification periods. Thus, the Board decided for practical reasons to modify the recognition approach to allow for those situations by referring to a minimum retention period determined based on the legal notification period, that is, the notification period that an entity is required to provide to employees in advance of a specified termination event as a result of an existing law, statute, or contract. In the absence of a legal notification requirement, that period is limited to 60 days, consistent with the minimum notification period of WARN.

Recognition and measurement

B30. This Statement specifies that employees are required to render future service if they are required to render service until they are terminated in order to receive the termination benefits (as proposed in the Exposure Draft) and will be retained to render service beyond the minimum retention period (as modified). The Board affirmed that if employees are required to render future service, the entity's communication of a promise to provide one-time termination benefits forms the basis for an exchange transaction between the entity and its employees. In exchange for the future services of employees who may be terminated, the entity promises to provide, in addition to current wages and other benefits, additional compensation in the form of one-time termination benefits.

B31. A similar exchange notion forms the basis for the conclusions reached by the Board in developing the accounting model for other employee benefits that, like those one-time termination benefits, "vest" and are payable at a future date (pensions and other postemployment benefits). A principal conclusion reached by the Board in developing that accounting model is that an employer's obligation for the additional compensation (in the form of benefits) is incurred and, therefore, should be recognized as employees render services necessary to earn the benefits. Paragraph 163 of FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* states:

> The Board concluded that the obligation to provide postretirement benefits meets the definition of a liability (paragraphs 152-158), is representationally faithful, is relevant to financial statement users, and can be measured with sufficient reliability at a justifiable cost. To imply by a failure to accrue that no obligation exists prior to the payment of benefits is not a faithful representation of what the financial statements purport to represent. The Board concluded that failure to recognize the existence of the obligation significantly impairs the usefulness and

credibility of the employer's financial statements.

B32. The Board decided that the recognition approach for one-time termination benefits should conform to the accounting model for other employee benefits if employees are required to render future service, noting that Concepts Statement 6 supports accruing for employee service as an exchange transaction. Paragraph 207 of Concepts Statement 6 states that "most liabilities result from exchange transactions in which an entity borrows funds or acquires goods or services and agrees . . . to pay for goods or services received. For example, using employees' services obligates an entity to pay wages or salaries and usually fringe benefits." Thus, this Statement requires that a liability for those one-time termination benefits be recognized as employees render service over the future service period.

B33. In reaching that decision, the Board considered and rejected an alternative approach that would have required that a liability for one-time termination benefits be recognized at the termination date if employees are required to render future service. That approach is based on the view that an entity does not have a present obligation that meets the definition of a liability until the termination date because, prior to that date, the entity has the discretion to reverse a decision to terminate employees without significant penalty. The Board concluded that such an approach, if adopted, would conflict with the accounting model for other employee benefits, noting that it had considered and rejected a similar approach when developing that accounting model. The Board decided that changes to that accounting model should be addressed in a separate project.

B34. Because the liability for those one-time termination benefits is incurred over time prior to the termination date, that is, over a future service period, the Board decided for practical reasons to modify the fair value measurement date. Specifically, the Board decided that a liability for those one-time termination benefits should be measured initially at the communication date based on the fair value of the liability *as of* the termination date and accrued ratably over the future service period. If the liability is not settled at the termination date, accretion expense should be recognized in accordance with paragraph 6 after that date.

B35. The Board clarified that the fair value of the liability as of the termination date should be adjusted for changes resulting from revisions to either the timing or the amount of estimated cash flows over the future service period using the catch-up approach discussed in Concepts Statement 7. That approach adjusts the carrying amount of the liability to the present value of the revised estimated cash flows, discounted at the credit-adjusted risk-free rate that was used to measure the liability initially. Paragraph 98 of Concepts Statement 7 states:

> The Board considers the catch-up approach to be preferable to other techniques for reporting changes in estimated cash flows because it is consistent with the present value relationships portrayed by the interest method and can be implemented at a reasonable cost. Under the catch-up approach, the recorded amount of an asset or liability, as long as estimated cash flows do not change, is

the present value of the estimated future cash flows discounted at the original effective interest rate. If a change in estimate is effected through the catch-up approach, the measurement basis after the change will be the same as the measurement basis for the same asset or liability before the change in estimate (estimated cash flows discounted at the original effective rate).

B36. This Statement specifies that employees are not required to render future service if employees are entitled to receive termination benefits covered by this Statement regardless of when they leave or if employees will not be retained to render service beyond the minimum retention period (regardless of when they are entitled to receive the termination benefits). The Board affirmed that if employees are not required to render future service, the entity's communication of a promise to provide one-time termination benefits creates an obligation at that date to provide the termination benefits. Absent an exchange for the future services of employees who may be terminated, that obligation is a present obligation that is incurred and, thus, meets the definition of a liability at the communication date. In that situation, a liability for the termination benefits should be recognized and measured at its fair value at the communication date, even though in some cases employees may be retained to render service for some future period (not to exceed the minimum retention period).

B37. During its redeliberations of the Exposure Draft, the Board decided to incorporate guidance, similar to the guidance previously included in Issue 94-3, clarifying the application of the requirements of this Statement for one-time involuntary termination benefits together with the requirements of FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits,* for special voluntary termination benefits. In that situation, a liability for the incremental voluntary termination benefit amount should be recognized in accordance with Statement 88 (that is, when the employee accepts the offer of special voluntary termination benefits), as previously required by Issue 94-3. The Board concluded that it was not necessary to reconsider that guidance in this Statement.

Differences between this Statement and Statement 112

B38. The Board acknowledges, as it did in the Exposure Draft, that the accounting for termination benefits will differ depending on whether the benefits are provided under a one-time benefit arrangement covered by this Statement or an ongoing benefit arrangement covered by FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*. Statement 112 requires that a liability for certain termination benefits provided under an ongoing benefit arrangement covered by that Statement be recognized when the likelihood of future settlement is probable, as that term is used in Statement 5. Thus, termination benefits that, based on the benefit formula, are attributable to past service may be recognized initially at a plan date if at that date it becomes probable that employees will be terminated and receive termination benefits under the benefit arrangement (the benefit arrangement having been communicated to employees previously, for example, at the date of hire). Further, Statement 112 permits, but does not require, discounting in measuring postemployment benefit obligations covered by that

Statement.

B39. During its deliberations leading to the Exposure Draft, the Board decided to address certain of those differences. Specifically, because not discounting is inconsistent with Concepts Statement 7, the Exposure Draft proposed to amend Statement 112 to preclude that alternative to the extent one-time termination benefits are granted in the form of enhancements to a postemployment benefit plan covered by that Statement. The Exposure Draft also proposed additional guidance for one-time termination benefits that are granted in the form of enhancements to an ongoing benefit arrangement consistent with that amendment. However, upon reconsideration, the Board concluded that those proposals, if retained, would create conflicts with how other postemployment benefits are accounted for and, in addition, could add unnecessary complexity in applying this Statement. The Board believes that, conceptually, liabilities for one-time termination benefit enhancements should be discounted. However, given its decision that changes to the accounting model for employee benefits should be addressed in a separate project, the Board decided not to address any of those differences in this Statement. Thus, this Statement does not retain the proposed amendment to Statement 112 or the additional guidance proposed in the Exposure Draft for one-time termination benefit enhancements to an ongoing benefit arrangement.

Contract Termination Costs

B40. This Statement applies to costs to terminate an operating lease or other contract that are (a) costs to terminate the contract before the end of its term or (b) costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity.

B41. Under Issue 94-3, a liability for costs to terminate a contract in situations involving an exit activity was recognized at the commitment date. For an operating lease, other accounting pronouncements addressed the accounting for similar costs to terminate the lease in other situations. For example, EITF Issue No. 88-10, "Costs Associated with Lease Modification or Termination," referred to the situation in which an entity (lessee) ceases using a property that is leased under an operating lease before the end of its term and enters into a replacement lease with a different lessor. Under Issue 88-10, a liability for the lease termination costs (including remaining lease rentals, reduced by actual or probable sublease rentals) was recognized when the leased property had "no substantive future use or benefit to the lessee." Issue 88-10 permitted, but did not require, discounting in measuring that liability.

B42. During its deliberations leading to the Exposure Draft, the Board reasoned that lease termination costs, in substance, are adjustments to the rentals specified by the lease (the agreed-upon exchange price at the inception of the lease) attributable to the total utilization period. The Board decided that, in contrast to Issue 94-3 and other accounting pronouncements, the recognition approach for lease termination costs should conform to the accounting model for operating leases, which requires that rental expense be allocated on a straight-line basis over the total utilization period as the entity uses the leased property. Thus, the Exposure Draft specified that if an entity's commitment to a plan makes it probable that the entity will cease using the leased property, lease termination costs should be allocated (accrued) over the total utilization period at the commitment date. A liability for the portion of those costs allocable to the past utilization period would be recognized at the commitment date, and a liability for the portion of those costs allocable to the future utilization period would be recognized (ratably) over that future period.

B43. Several respondents to the Exposure Draft disagreed with that approach. They indicated that allocating lease termination costs over the total utilization period would, among other things, result in "excessive" rental expense during the future utilization period, noting that the entity likely will receive reduced benefit from its use of the leased property during that period. Some respondents also said that the proposed method of allocation, based on the ratio of the past and future utilization periods to the total utilization period, would represent a significant change in current practice that would not improve financial reporting and, in some cases, would be unnecessarily complex.

B44. During its redeliberations of the Exposure Draft, the Board reconsidered the recognition approach for lease termination costs. The Board observed that those costs arise from the rights and obligations conveyed by an operating lease. The Board agreed that, conceptually, those rights and obligations give rise to assets and liabilities at the inception of the lease and that recognition of some (or all) of those rights and obligations at that time would be consistent with the recognition requirements of this Statement (paragraph 3). However, the Board observed that because the rights and obligations under an operating lease are not recognized as assets and liabilities in the financial statements of an entity (lessee), applying those recognition requirements to an operating lease that is included in the scope of this Statement would conflict with the accounting model for operating leases. The Board decided that changes to that accounting model should be addressed in a separate project. In view of that decision, the Board decided for practical reasons that this Statement should specify the event for recognition of a liability for costs to terminate an operating lease and, further, that the same event should apply for recognition of a liability for costs to terminate the other contracts included in the scope of this Statement.

B45. The Board considered and rejected an approach that would have required that a liability for contract termination costs be recognized at the date of an entity's commitment to an exit or disposal plan—a commitment date approach similar to the approach in Issue 94-3. The Board concluded that a commitment date approach, based on the intended actions of an entity at a plan (commitment) date, would be discretionary. In addition, that approach raises issues that are beyond the scope of this Statement about the accounting for impairment losses on firmly committed executory contracts (including operating leases).

B46. The Board decided that a liability for costs to terminate a contract before the end of its term should be recognized and measured at its fair value when an entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty). The Board concluded that having exercised its option to terminate a contract by communicating that decision to the counterparty, an entity has a legal obligation under the contract for the penalty or other costs specified by the contract.

B47. The Board decided that a liability for other costs that will continue to be incurred under a contract for its remaining term without economic benefit to an entity should be recognized and measured at its fair value when the entity ceases using the right conveyed by the contract (for example, the right to use a leased property or to receive future goods or services)—a cease-use date approach similar to the recognition approach in Issue 88-10. The Board concluded that a cease-use date approach is less discretionary than a commitment date approach because it does not rely on an entity's intended actions at a plan (commitment) date. The Board also observed that a cease-use date approach can be applied consistently, regardless of whether the termination involves an operating lease or other contract. Because the measurement approach in Issue 88-10 permits but does not require discounting, the Board decided that this Statement's cease-use date approach and its requirement for a fair value measurement at that date should apply for a liability for costs to terminate an operating lease in the situation referred to in Issue 88-10. Thus, this Statement substantially nullifies Issue 88-10.

B48. The Board acknowledged that for an operating lease, a cease-use date approach might not eliminate discretion if an entity does not give up its right to use the leased property by terminating the lease or entering into a sublease. For example, the entity could, at its discretion, place the property back in use after having recognized a liability for the future lease rentals (rental expense) otherwise allocable to that future utilization period. However, the Board decided not to modify or otherwise reconsider the cease-use date approach to address that situation. The Board reasoned that if sublease rentals could be reasonably obtained for the property, an entity likely would enter into a sublease. Alternatively, if sublease rentals could not be reasonably obtained for the property, or if the entity chooses for other reasons not to enter into a sublease, the fact that the entity has ceased using the property generally would provide evidence that the entity will not use the property for the remaining lease term.

B49. If an operating lease is not terminated, this Statement requires that measurement of the fair value of the liability at the cease-use date be determined based on the remaining lease rentals, reduced by estimated sublease rentals that could be reasonably obtained for the property, regardless of whether the entity intends to enter into a sublease. The Exposure Draft proposed a similar requirement, with which some respondents disagreed. They said that there may be valid reasons for deciding not to sublease a leased property and that, in those situations, it would be inappropriate to reduce the liability for the remaining lease rentals by "unexpected and hypothetical" sublease rentals.

B50. In response to those concerns, this Statement clarifies that, absent a decision to sublease a leased property, measurement of the fair value of the liability should consider estimated sublease rentals only to the extent that such sublease rentals could be *reasonably* obtained for the property. The Board affirmed that because fair value is a market-based measure, a liability (loss) should be recognized at the cease-use date only if the terms of an operating lease are unfavorable relative to the terms of a new lease for a similar property. Also, the Board observed, as it did in the Exposure Draft, that although an operating lease may be noncancellable by its terms, if a lessee breaches its lease agreement, the lessor may be required by law to mitigate its damages (for example, by taking reasonable steps to locate a new tenant). Thus, if the leased property can be subleased, reducing the remaining lease rentals by estimated sublease rentals would measure the entity's (lessee's) obligation under the lease agreement as the amount of its potential damages in the event of a breach.

Other Associated Costs

B51. This Statement also applies to other costs associated with an exit or disposal activity. Under Issue 94-3, a liability for exit costs as defined in Issue 94-3 (such as costs to consolidate or close facilities) was recognized at the commitment date. A liability for other costs that were not exit costs (such as costs to relocate employees) was recognized in the period in which the liability was incurred. This Statement eliminates that difference, requiring that a liability for a cost associated with an exit or disposal activity be recognized in the period in which the liability is incurred, for example, when goods or services related to an exit or disposal activity are received. Paragraph 194 of Concepts Statement 6 clarifies:

> The most obvious evidence of liabilities are contracts or other agreements resulting from exchange transactions and laws or governmental regulations that require expending assets to comply. Although receipt of proceeds is not conclusive evidence that a liability has been incurred (paragraph 198), receipt of cash, other assets, or services without an accompanying cash payment is often evidence that a liability has been incurred.

B52. This Statement similarly requires that future operating losses expected to be incurred in connection with an exit or disposal activity be recognized in the period(s) in which they are incurred. During its deliberations of this Statement, the Board clarified that because future operating losses are the summation of individual items of revenue and expense that result from changes in assets and liabilities, those expected losses, in and of themselves, do not meet the definition of a liability. In Statement 144, the Board clarified that future operating losses expected to be incurred in connection with the sale of a long-lived asset or disposal group, including a component of an entity that is a discontinued operation, should not otherwise be recognized by including those losses in the measurement of the asset or disposal group. As discussed in footnote 22 to paragraph 35 of Statement 144:

> Expected future operating losses that marketplace participants would not similarly consider in their estimates of the fair value less cost to sell of a long-lived asset (disposal group) classified as held for sale shall not be indirectly recognized as part of an expected loss on the sale by reducing the carrying amount of the asset

(disposal group) to an amount less than its current fair value less cost to sell.

Reporting and Disclosure

B53. Issue 94-3 provided guidance for reporting costs associated with an exit activity in the income statement, requiring that those costs be included in continuing operations (before income taxes). During its redeliberations of the Exposure Draft, the Board decided that similar reporting requirements should apply for costs associated with an exit or disposal activity covered by this Statement that does not involve a discontinued operation. The Board decided not to prohibit separate presentation of those costs in the income statement. However, because neither an exit activity nor a disposal activity is both unusual and infrequent, the Board decided to prohibit those costs from being presented in the income statement net of income taxes or in any manner that implies they are similar to an extraordinary item, as defined in Opinion 30. If an exit or disposal activity involves a discontinued operation, costs associated with that activity should be included within the results of discontinued operations in accordance with Statement 144.

B54. Issue 94-3 also set forth disclosure requirements for costs associated with an exit activity. During its redeliberations of the Exposure Draft, the Board affirmed its decision that similar disclosure requirements should apply for costs associated with an exit or disposal activity covered by this Statement. The Board concluded that because those disclosure requirements focus on the major types of costs associated with an exit or disposal activity, they provide information that is useful to investors, creditors, and other users in assessing the overall effects of that activity on an entity's ongoing operations. The Board concluded that the principal focus of the required disclosures for one-time termination benefits should be on the amounts to be paid. Accordingly, this Statement eliminates the requirement of Issue 94-3 to disclose information about the number of employees to be (or actually) terminated. However, it does not prohibit disclosure of that or other information about an exit or disposal activity.

B55. Few respondents to the Exposure Draft commented specifically on the proposed disclosure requirements for costs associated with an exit or disposal activity. However, during its redeliberations of the Exposure Draft, the Board decided that the disclosures previously required by Issue 94-3 and retained in this Statement should be presented as a reconciliation of the beginning and ending liability balances for each major type of cost associated with the activity and should include an explanation of the reasons for adjustments, if material. The Board concluded that a reconciliation format would improve the comparability of information provided about exit and disposal activities and aid users in assessing the effects of such activities over time, including the related cash flow implications. Also, given the importance of segment information, the Board decided that entities that are within the scope of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information,* should disclose, by reportable segment, the amount of costs incurred in connection with those activities in the current period and the cumulative amount to date.

B56. During its deliberations leading to the Exposure Draft, the Board observed that certain costs that were recognized as liabilities at a plan (commitment) date under Issue 94-3 would be recognized as liabilities at a later date under this Statement. The Board concluded that information about the costs the entity expects to incur in connection with an exit or disposal activity is useful in assessing the effects of the activity initially and over time. For that reason, the Board decided to require disclosure of the major types of costs expected to be incurred in connection with the exit or disposal activity at the date an entity initiates a plan, whether or not a liability for those costs is recognized at that date. The Board affirmed that decision in this Statement.

Effective Date and Transition

B57. The Board decided that this Statement should be effective for exit or disposal activities initiated after December 31, 2002. The Board believes that that effective date provides sufficient time for entities and their auditors to analyze, interpret, and prepare for implementation of the provisions of this Statement. The Board encourages early application of this Statement. Retroactive application of this Statement is prohibited.

B58. During its deliberations leading to the Exposure Draft, the Board decided that the provisions of the Exposure Draft for all disposal activities should be applied prospectively. In this Statement, the Board affirmed prospective application for costs associated with asset disposal activities and other similar activities, including exit activities under Issue 94-3. The Board believes that using the date that management, having the authority to approve the action, commits to an exit or disposal plan as a basis for applying the provisions of this Statement initially will facilitate transition to the provisions of this Statement.

B59. The Board recognizes the benefits of comparative financial statements. However, the Board observed that applying this Statement retroactively would require entities to (a) reverse liabilities recognized in prior periods and (b) determine fair value measurements for liabilities that would continue to be recognized in those prior periods under this Statement. The Board concluded that obtaining or deriving the information necessary to apply this Statement retroactively could be costly and unduly burdensome for many entities. In particular, the Board questions the ability of entities to retroactively assess when the recognition criteria in this Statement would otherwise have been met in those prior periods based on facts and circumstances as they existed at that time and without the benefit of hindsight. Further, the Board observed that in many cases the related exit or disposal activity will have been completed and the liabilities settled before this Statement is initially applied. In other cases in which the exit or disposal activity is in process at the date this Statement is initially applied, information about that activity would have been disclosed and communicated to users in a prior period. The Board concluded that applying this Statement retroactively generally would not provide users with sufficiently useful additional information to justify the related costs. Moreover, because liabilities associated with an exit or disposal activity generally are short-lived, prospective application should not have a significant, continuing impact on the comparability and consistency of the financial statements.

International Accounting Standards

B60. The International Accounting Standard for costs associated with a restructuring other than employee termination benefits is IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (1998). Paragraph 13 of IAS 37 defines a *restructuring* as a "programme that is planned and controlled by management, and materially changes either: (a) the scope of a business undertaken by an enterprise; or (b) the manner in which that business is conducted." The International Accounting Standard for employee termination benefits is IAS 19, *Employee Benefits* (revised 2000).

B61. For costs associated with a restructuring other than employee termination benefits, the recognition guidance in IAS 37 is similar to that previously included in Issue 94-3 for exit costs and, in addition, requires public announcement (or implementation) of an exit plan. Because this Statement does not retain the definition or requirements for recognition of exit costs, the timing of recognition of a liability for similar costs under IAS 37 and this Statement will differ. For purposes of measurement, IAS 37 refers to settlement of the present obligation at the balance sheet date, which is similar to fair value. However, the extent to which initial measurements under IAS 37 and this Statement will be similar will depend on, among other things, how the measurement objective of IAS 37 is interpreted and the specific measurement approaches used to achieve that objective under IAS 37.

B62. Paragraph 132 of IAS 19 states that the accounting model for employee benefits does not apply to employee termination benefits because "the event which gives rise to an obligation is the termination rather than employee service." Paragraph 137 of IAS 19 explains that because employee termination benefits do not provide an enterprise with future economic benefits, they are recognized as an expense immediately. In this Statement, the accounting model for employee benefits is used for one-time termination benefits that, in substance, are stay bonuses provided by an entity in exchange for the employees' rendering of service over a future period. Thus, the accounting for certain employee termination benefits under IAS 19 and this Statement will differ, even though the benefit arrangements may be similar. However, the Board believes that the accounting model for employee benefits more faithfully represents the underlying economics of stay bonus arrangements.

B63. In developing this Statement, the Board acknowledged those differences, noting that they arise from linking the recognition and measurement requirements for costs associated with an exit or disposal activity to fundamental concepts in the Board's conceptual framework. The Board concluded that, at this time, the benefits resulting from the improvements to financial reporting under this Statement outweigh the costs resulting from the lack of convergence with those International Accounting Standards.

Benefits and Costs

B64. The mission of the Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—as well as others, benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

B65. The Board determined that the requirements in this Statement will result in a significant improvement to financial reporting. Prior to this Statement, the liability recognized for some costs associated with an exit or disposal activity did not meet the definition of a liability set forth in the Board's conceptual framework. Moreover, Issue 94-3 and other accounting pronouncements did not require that a liability be measured initially at its fair value. This Statement addresses those differences, requiring that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred and setting forth a fair value objective for initial measurement of the liability, thereby improving comparability in financial reporting. As discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information,* providing comparable financial information enables users to identify similarities in and differences between two sets of economic events.

B66. The principal cost of applying this Statement is the cost of measuring the fair value of a liability for a cost associated with an exit or disposal activity at initial recognition. Other accounting pronouncements require fair value measurements, and techniques for developing those measurements, including the expected present value technique discussed in Concepts Statement 7, are currently being applied. As a practical matter, however, in many cases, the related liability will be relatively short-lived, mitigating the need to apply complex valuation techniques in order to derive the fair value measurements required by this Statement. In addition, the Board believes that prospective application with a delayed effective date further reduces the costs of implementing this Statement. While some entities may incur one-time costs to apply this Statement, in particular, for changes needed to apply present value and other valuation techniques to liabilities, the benefits from more comparable information will be ongoing. The Board believes that the benefits of this Statement outweigh the costs of implementing it.

Footnotes

FAS146, Footnote 1—For purposes of this Statement, an *exit activity* includes but is not limited to a *restructuring* as that term is defined in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Paragraph 10 of IAS 37 defines a restructuring as "a programme that is planned and controlled by management, and materially changes either: (a) the scope of a business undertaken by an enterprise; or (b) the manner in which that business is conducted." A restructuring covered by IAS 37 (paragraph 70) includes the sale or termination of a line of business, the closure of business activities in a particular location, the relocation of business activities from one location to another, changes in management structure, and a fundamental reorganization that affects the nature and focus of operations.

FAS146, Footnote 2—EITF Issue No. 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination," provides guidance on the accounting for costs associated with an exit activity that involves a company newly acquired in a business combination. The Board is reconsidering that guidance in its project on business combinations—purchase method procedures.

FAS146, Footnote 3—Statement 144 addresses the accounting for the impairment of long-lived assets and for long-lived assets and disposal groups to be disposed of, including components of an entity that are discontinued operations.

FAS146, Footnote 4—FASB Statements No. 87, *Employers' Accounting for Pensions,* No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits,* No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* and No. 112, *Employers' Accounting for Postemployment Benefits,* address the accounting for other employee benefits. APB Opinion No. 12, *Omnibus Opinion—1967,* as amended by Statement 106, addresses the accounting for deferred compensation contracts with individual employees. This Statement does not change the accounting for termination benefits, including one-time termination benefits granted in the form of an enhancement to an ongoing benefit arrangement, covered by those accounting pronouncements.

FAS146, Footnote 5—FASB Statement No. 13, *Accounting for Leases*, addresses the accounting for the termination of a capital lease (paragraph 14(c)).

FAS146, Footnote 6—Accretion expense shall not be considered interest cost for purposes of applying FASB Statement No. 34, *Capitalization of Interest Cost*, or for purposes of classification in the income statement (statement of activities).

FAS146, Footnote 7—Absent evidence to the contrary, an ongoing benefit arrangement is presumed to exist if an entity has a past practice of providing similar termination benefits.

FAS146, Footnote 8—*Legal notification period* refers to the notification period that an entity is required to provide to employees in advance of a specified termination event as a result of an existing law, statute, or contract. For example, in the United States, the Worker Adjustment and Retraining Notification Act requires entities with 100 or more employees to notify employees 60 days in advance of covered plant closings and mass layoffs, unless otherwise specified. Collective bargaining or other labor contracts may require different notification periods.

FAS146, Footnote 9—Paragraph 15 of Statement 88 states, "An employer that offers special termination benefits to employees shall recognize a liability and a loss when the employees accept the offer and the amount can be reasonably estimated."

FAS146, Footnote 10—This Statement does not address impairment of an unrecognized asset while it is being used. The EITF is addressing related issues in Issues No. 99-14, "Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts," and No. 00-26, "Recognition by a Seller of Losses on Firmly Committed Executory Contracts."

FAS146, Footnote 11—The remaining lease rentals should be adjusted for the effects of any prepaid or deferred items recognized under the lease.

FAS146, Footnote 12—Paragraphs 41–44 of Statement 144 address the reporting of discontinued operations.

FAS146, Footnote 13—Paragraph 62 of FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements,* explains:

An estimate of fair value should include the price that marketplace participants are able to receive for bearing the uncertainties in cash flows—the adjustment for risk—if the amount is identifiable, measurable, and significant. An arbitrary adjustment for risk, or one that cannot be evaluated by comparison to marketplace information, introduces an unjustified bias into the measurement. On the other hand, excluding a risk adjustment (if it is apparent that marketplace participants include one) would not produce a measurement that faithfully represents fair value. There are many techniques for estimating a risk adjustment, including matrix pricing, option-adjusted spread models, and fundamental analysis. However, in many cases a reliable estimate of the market risk premium may not be obtainable or the amount may be small relative to potential measurement error in the estimated cash flows. In such situations, the present value of expected cash flows, discounted at a risk-free rate of interest, may be the best available estimate of fair value in the circumstances.

FAS146, Footnote 14—Paragraph 23 of Concepts Statement 7 discusses the essential elements of a present value measurement.

FAS146, Footnote 15—When using an expected present value technique, the effect of an entity's credit standing can be reflected in either the discount rate or the estimated cash flows. However, it is usually easier and less complex to reflect that adjustment in the discount rate.

FAS146, Footnote 16—Paragraph 38 of Concepts Statement 7 explains:

As a practical matter, an entity that uses cash flows in accounting measurements often has little or no information about some or all of the assumptions that marketplace participants would use in assessing the fair value of an asset or a liability. In those situations, an entity must necessarily use the information that is available without undue cost and effort in developing cash flow estimates. The use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there are no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.

FAS146, Footnote 17—In this case, a risk premium is not considered in the present value measurement. Because the amounts of the cash flows will be fixed and certain as of the termination date, marketplace participants would not demand a risk premium.

FAS146, Footnote 18—In this case, a risk premium is not considered in the present value measurement. Because the lease rentals are fixed by contract and the estimated sublease rentals are based on market prices for similar leased property for other entities having similar credit standing as the entity, there is little uncertainty in the amount and timing of the expected cash flows used in estimating fair value at the cease-use date and any risk premium would be insignificant. In other circumstances, a risk premium would be appropriate if it is significant.

FAS146, Footnote 19—At that time, the definition of a liability in paragraph 132 of APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,* incorporated the view that the matching of costs and revenues to avoid "distortions" in reporting of income was the central function of financial accounting. In addition to economic obligations of an enterprise, the Accounting Principles Board's definition of a liability included "certain deferred credits that are not obligations but that are recognized and measured in conformity with generally accepted accounting principles" (footnote references omitted).

FAS146, Footnote 20—Statement 5 uses the term *probable* in a different sense than the term is used in the definition of a liability. In Statement 5, probable refers to a high degree of expectation. In the definition of a liability, probable is intended to acknowledge that business and other economic activities occur in an environment in which few outcomes are certain.

FAS146, Footnote 21—Concepts Statement 7 does not specify when fresh-start measurements are appropriate. Paragraph 14 of Concepts Statement 7 clarifies that the Board expects to decide whether a particular situation requires a fresh-start measurement or some other accounting response on a project-by-project basis.

FAS146, Footnote 22—As noted in paragraph 2 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* "the Board intends future change [in practice] to occur in the gradual, evolutionary way that has characterized past change."

FAS146, Footnote 23—Paragraphs 55–61 of Concepts Statement 7 discuss the relations between the fair value measurement objective discussed in Concepts Statement 7 and accounting for contingencies under Statement 5.

FAS146, Footnote 24—For a recognized asset (or liability), the definition of an asset (or liability) having been met previously, an entity's commitment to a plan may be relevant in determining whether to reclassify and, in certain circumstances, remeasure the asset (or liability)—as is the case for a long-lived asset (disposal group) to be disposed of under Statement 144. However, reclassification and remeasurement issues are fundamentally different from initial recognition issues. An entity's commitment to a plan, by itself, is not sufficient for initial recognition of an asset (or liability).