Statement of Financial Accounting Standards No. 74

Note: This Statement has been completely superseded

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Accounting for Special Termination Benefits Paid to Employees

August 1983

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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Statement of Financial Accounting Standards No. 74

Accounting for Special Termination Benefits Paid to Employees

August 1983

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Paragraph Numbers

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FAS 74: Accounting for Special Termination Benefits Paid to Employees

FAS 74 Summary

This Statement applies when an employer offers for a short period of time special termination benefits to its employees. The employer is to recognize special termination benefits as a liability and an expense when the employees accept the offer and the amount can be reasonably estimated. The amount to be recognized includes any lump-sum payments and the present value of any expected future payments. If reliably measurable, certain changes in the estimated costs of other employee benefits are also to be included in measuring the expense.

This Statement applies for special termination benefits offered after June 30, 1983, with earlier application encouraged. Restatement of previously issued financial statements is permitted.

INTRODUCTION

1. An employer may offer for a short period of time special benefits to its employees in connection with their termination of employment (special termination benefits). The employees to whom the benefits are offered may vary but often include employees who have reached the early retirement age specified in the employer's pension plan. The special termination benefits can take different forms, such as a lump-sum payment or periodic future payments or both. They may be paid directly from an employer's assets, an existing pension plan, a new employee benefit plan, or a combination of those means. Some believe that the cost of special termination benefits should be recognized as an expense of future periods. Others believe that the cost of those benefits should be immediately expensed. The AICPA Accounting Standards Executive Committee requested that the FASB provide guidance on this issue because of the diversity of views. That diversity was confirmed by the comments received in response to the FASB Exposure Draft, *Accounting for Special Termination Benefits Paid to Employees* (December 28, 1982).

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STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

2. An employer that offers for a short period of time special termination benefits to employees shall recognize a liability and an expense when the employees accept the offer and the amount can be reasonably estimated. The amount recognized shall include any lump-sum payments and the present value of any expected future payments.

3. The termination of employees under a special termination benefit arrangement may affect the estimated costs of other employee benefits, such as pension benefits, because of differences between past assumptions and actual experience. If reliably measurable, the effects of any such changes on an employer's previously accrued expenses for those benefits that result directly from the termination of employees shall be included in measuring the termination expense.[1]

Amendment to APB Opinion No. 8

4. The following footnote is added to the end of the last sentence of paragraph 31 of APB Opinion No. 8, *Accounting for the Cost of Pension Plans,* to elaborate on the examples cited in that paragraph:

> *Paragraph 3 of FASB Statement No. 74, *Accounting for Special Termination Benefits Paid to Employees,* identifies another situation for which an actuarial gain or loss is immediately recognized.

Effective Date and Transition

5. This Statement shall be applied for special termination benefits offered after June 30, 1983. Earlier application is encouraged. Restatement of previously issued financial statements is permitted but is not required.

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. March dissented.

Mr. March dissents because he believes that the requirement in paragraph 2 making employee acceptance of the employer's offer of termination benefits a condition precedent to recognizing a liability is an undesirable bar to recognition that could cause failure to report a loss known to have occurred. The definition of a liability, cited in paragraph 11 of this Statement, does not require acceptance by the obligee when the effect of probable acceptance is known or

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reasonably estimable and when, as the Board finds in paragraph 12, such acceptance does not give rise to the future acquisition of an asset (future economic benefit). He believes that users' reasonable expectations are that known losses have been reflected in financial statements. That objective should take priority over the emphasis on legal obligation that is implicit in requiring prior acceptance. He also believes that the Board's decision to require acceptance is inconsistent with the guidance for accruing severance pay and additional pension costs in paragraph 17 of APB Opinion No. 30, *Reporting the Results of Operations,* for discontinuance of a business segment, cited in paragraph 12 of this Statement as being a similar situation. The provisions of paragraphs 2 and 3 of the Statement (as explained in paragraph 17) specifying that the effect of employees' acceptances must be "reasonably estimated" or "reliably measurable" are adequate assurance against accruals for offers of uncertain outcome.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
Victor H. Brown
John W. March
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix: BASIS FOR CONCLUSIONS

6. An Exposure Draft of a proposed Statement, *Accounting for Special Termination Benefits Paid to Employees,* was issued on December 28, 1982. The Board received 160 letters of comment in response to the Exposure Draft. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing. This appendix discusses the significant comments received on the Exposure Draft and the factors deemed significant by the Board in reaching the conclusions in this Statement. Individual Board members gave greater weight to some factors than to others.

Need for Statement

7. Many respondents suggested that the Board combine the project on special termination benefits with its project on employers' accounting for pensions and other postemployment benefits. Other respondents questioned the need for a Statement that specifies how an employer should account for special termination benefits. Although they generally agreed with the proposed standards, they expressed the view that a careful reading of Opinion 8 and FASB Statement No. 5, *Accounting for Contingencies,* leads to the same result.

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8. The Board concluded that it should address this issue now because of the significance of recent termination offers and the differences of opinion on the proper accounting for special termination benefits as evidenced by respondents' comments.

Recognition and Measurement

9. Some respondents expressed the view that Opinion 8 applies if special termination benefits are offered through an amendment to an existing pension plan. They concluded that special termination benefits offered through a plan amendment represent prior service costs which are recognized as an expense of future periods under Opinion 8.

10. The Board recognizes that special termination benefits may be paid from a pension plan, but it believes that the source of payment should not determine the accounting. The Board believes that an assumption underlying Opinion 8 is an employer's ongoing commitment to provide pension benefits in exchange for employees' services. Because special termination benefits are offered only for a short period of time and in exchange for employees' termination of service, the Board concluded that the accounting for those benefits is excluded from the scope of Opinion 8.

11. Paragraph 28 of FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* 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.]

The Board believes that an employer's obligation for special termination benefits meets that definition of a liability when the employees accept the offer (paragraph 18).

12. Some respondents believe that an employer's incurring a liability for special termination benefits results in its acquiring future economic benefits that should be recognized as an asset. Most of those respondents stated that the future economic benefits are the salaries and other employee costs that will be avoided because of the employees' termination. The Board believes that the avoidance of future employee costs does not result in the acquisition of an asset under the facts and circumstances dealt with in this Statement. Special termination benefits are generally offered to eliminate or mitigate an existing unfavorable situation. Termination of employees' services is similar to discontinuance of a business segment in that as a result of either of those actions future results of operations provided by the remaining assets or work force may improve when compared with the past performance of the enterprise. Other respondents indicated that the future economic benefits could also include improved productivity and reduced employee turnover, thereby enhancing the value of continuing employees' future services. The Board believes that there is sufficient uncertainty about whether and to what extent the employer will obtain those benefits to preclude recognition of an asset.

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13. Some respondents suggested that special termination benefits are similar to improvements in retirees' benefits and pointed to Preliminary Views of the FASB, *Employers' Accounting for Pensions and Other Postemployment Benefits,* which indicates that such improvements give rise to probable future economic benefits that qualify as an intangible asset. All Board members agree that incurring an obligation for special termination benefits does not result in the acquisition of an asset. The Board notes that it will not reach a conclusion on the issue concerning improvements in retirees' benefits until after the Board has considered comments on the Preliminary Views and further deliberated all of the issues concerning employers' accounting for pensions. However, the Board believes that conclusion would not affect the decision relating to special termination benefits.

14. The Exposure Draft specified that any "accounting actuarial gain (loss)" related to an existing employee benefit plan that results from the employee terminations should be immediately recognized. Some respondents indicated that the term *accounting actuarial gain (loss)* was confusing and requested that the Board further clarify the nature of that gain (loss). Other respondents indicated that it is difficult, if not impossible, to reliably measure those gains (losses) in many circumstances, and therefore, immediate recognition should not be required.

15. The Board agreed that the term *accounting actuarial gain (loss)* was not clear. Accordingly, the Board decided to clarify the matter and not use that term. The termination of employees under a special termination benefit arrangement may affect the cost of other employee benefits, such as pension benefits, because of differences between past assumptions and actual experience. For example, there may be an additional pension cost if the pension plan does not require any actuarial reduction of benefits for early retirement and previously estimated pension costs for the terminating employees have been based on the assumption of a later retirement age. As another example, pension costs for the terminating employees may be reduced if they have been based on expected salary levels and service to normal retirement age. The Board believes that the effects of any such changes on an employer's previously accrued expenses for other employee benefits that result *directly* from the termination of employees should be included in measuring the termination expense. The Board believes that this result is consistent with the intent of paragraph 31 of Opinion 8.

16. Terminating employees may have other benefits whose costs have not been fully accrued. The Board concluded that previously existing unaccrued costs should not be considered in measuring the termination expense. Any increases in those unaccrued costs that result directly from the termination of employees would be included in measuring the termination expense. However, any decreases in those unaccrued costs would not be included in measuring the expense. For example, the actuarial liability under the actuarial cost method used by the employer for its pension plan may be reduced as a result of the termination of employees. Termination expense would be reduced only to the extent that the actuarial liability being reduced represents pension expense previously accrued in the employer's financial statements. The Board also concluded that past investment performance more or less favorable than that

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assumed in measuring previously accrued pension expense should not be included in measuring the termination expense.

17. The Board agrees with those respondents who indicated that it may not be possible in many situations to reliably measure the effects of the employees' termination on the costs of other benefits that should be immediately recognized. Situations cited include (a) an implicit (versus explicit) approach to actuarial assumptions has been followed, (b) changes in actuarial assumptions have preceded the offer of termination benefits, and (c) previously accrued expenses cannot be allocated between terminated employees and other plan participants. Accordingly, this Statement requires that such effects be immediately recognized only if reliably measurable.

18. Some respondents asked the Board to clarify whether the termination liability and expense should be recognized when the employer offers termination benefits or when employees accept the offer. As noted in paragraphs 2 and 11, the Board concluded that the employer incurs a liability when employees accept the offer and that the termination expense should be recognized at that time. The Board believes that a liability and an expense for special termination benefits result from an exchange transaction and that neither a liability nor an expense is incurred until that exchange takes place. That accounting is consistent with accounting for other exchange transactions. Although there are similarities between termination of employees through an offer of special termination benefits and discontinuance of a business segment (paragraph 12), the Board believes the differences between them call for recognizing their effects at different dates. APB Opinion No. 30, *Reporting the Results of Operations,* requires severance pay and additional pension costs expected in connection with the discontinuance of a business segment to be accrued when management adopts a formal plan for such discontinuance. That Opinion is concerned with recognizing the impairment of assets intended to be disposed of and any related expenses. In that situation, employees' termination is a unilateral decision of the employer, not an exchange transaction.

19. Some respondents expressed the view that, if adopted, the provisions of the Exposure Draft would deter employers from offering special termination benefits. The Board was not persuaded by that view. The Board believes that financial reporting must reflect economic activity as faithfully as possible without coloring the image it communicates for the purpose of influencing behavior in any particular direction.

Effective Date and Transition

20. The Exposure Draft proposed that this Statement be effective for special termination benefits offered in fiscal years ending after April 15, 1983. The Board concluded, however, that the effective date and transition specified in paragraph 5 are advisable primarily because of the additional clarification concerning the "accounting actuarial gain (loss)."

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Footnotes

FAS74, Footnote 1--Additional guidance for applying this provision is provided in paragraphs 14 through 17.

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