



Financial Reporting

November 2002

Accounting for Costs Associated with Exit or Disposal Activities

Introduction

On July 30, 2002, the Financial Accounting Standards Board issued FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. Statement 146 covers a wide range of costs, including lease termination costs and certain employee severance costs that are associated with a restructuring, discontinued operation, or other exit or disposal activity. Statement 146 takes a further step in the effort to eliminate so called “big bath” charges, which have long concerned the Securities and Exchange Commission. The most significant effect of applying Statement 146 will be the timing of cost recognition. It requires companies to recognize costs associated with exit or disposal activities only when liabilities for those costs are incurred rather than at the date of a commitment to an exit or disposal plan. Statement 146 also requires a company to initially measure liabilities for exit and disposal activities at fair value. It replaces Emerging Issues Task Force (EITF) Issues No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restruc-*

turing) and No. 88-10, *Costs Associated with Lease Modification or Termination*. The provisions of Statement 146 are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged.

Background

Over the past several years, many companies have restructured their operations by exiting or disposing of activities. Because accounting guidance for these actions was inconsistent, the FASB added a project to its agenda in 1996 to revisit the issues and to establish a single accounting model for the recognition and measurement of a liability associated with an exit or disposal activity. 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*. (For a detailed analysis of Statement 144 go to http://www.bdo.com/about/publications/assurance/fr_feb_02yir/finalimp.asp.) The issuance of Statement 146 completes the second and final phase of the project.

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Scope

Statement 146 applies to all non-governmental entities, including not-for-profit organizations. It provides accounting and reporting guidance for costs associated with an exit activity or with a disposal activity within the scope of Statement 144. Statement 146, however, specifically *excludes* from its scope:

- Costs to exit an activity associated with an entity newly acquired in a business combination (the Board is reconsidering the accounting for these costs in its project on business combinations – purchase method procedures; current accounting guidance for these costs can be found in EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*)
- Costs to terminate a capital lease
- Voluntary and involuntary termination benefits, including one-time termination benefits, that enhance an existing benefit plan arrangement within the scope of other accounting guidance¹
- Costs to retire a long-lived asset covered by FASB Statement 143, *Accounting for Asset Retirement Obligations* (e.g., costs incurred to close a landfill).

The Board did not provide a definition of an exit activity. However, they indicated that the costs associated with exit or disposal activities within the scope of

Statement 146 would include, but are not limited to:

- One-time employee termination benefits
- Termination of a contract that is not a capital lease
- Consolidation of facilities or relocation of employees.

The Board also concluded that an exit activity might include a restructuring. Statement 146 uses the definition of a restructuring found in International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets*. A restructuring is a program 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.”

Restructuring activities include:

- Changing the management structure
- Moving business activities from one location to another
- Closing of business activities in a particular location
- Reorganizing the company in a way that fundamentally affects the nature and focus of operations
- Selling or terminating a line of business.

Recognition and Measurement – General

Except for certain one-time employee termination benefits (see

below for further discussion), a liability for an exit or disposal activity cost should be recognized and initially measured at its fair value when it is *incurred*. A liability is considered to be incurred when it is a probable future sacrifice of economic benefits arising from present obligations to transfer assets or provide services in the future as a result of past transactions or events. In essence, an obligation becomes a liability at the point when the company has little or no discretion to avoid the future transfer or use of assets to settle the liability. In Statement 146, the Board concluded that management approval of an exit plan merely reflects an intended action and does not create a present obligation to others nor does it result in a requisite past transaction or event for recognition of a liability. This is a significant change from the consensus reached by the EITF in Issue No. 94-3. In those rare instances when a company is unable to reasonably estimate the liability’s fair value when the liability is incurred, the company should recognize the liability in the later period when it can reasonably estimate the fair value.

Fair Value

Consistent with other FASB Statements, 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-

¹ Statement 146 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 the following pronouncements:

- FASB Statement No. 87, *Employers’ Accounting for Pensions*
- FASB Statement No. 88, *Employers’ Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*
- FASB Statement No. 106, *Employers’ Accounting for Postretirement Benefits Other Than Pensions*
- FASB Statement No. 112, *Employers’ Accounting for Postemployment Benefits*
- APB Opinion No. 12, *Omnibus Opinion—1967*, as amended by Statement 106.

tion transaction. Paragraph A2 of Statement 146 states:

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. [Footnote reference omitted.]

Quoted market prices are the best evidence of fair value, and a company should use them as the basis for measurement, if available. However, the Board acknowledged that quoted market prices will not be available for many of the liabilities within the scope of Statement 146. Absent quoted market prices, a company should base the measurement on the best information available in the circumstances, including prices for similar liabilities and the results of using other valuation techniques. Generally, the best available information to develop a reasonable estimate of a liability's fair value is the present value of future cash outflows. Statement 146 and FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provide detailed guidance about using present value techniques to estimate the fair value of a liability.

Subsequent Measurement

A company is not required to remeasure liabilities for costs associated with exit or disposal activities to reflect changes in interest rates. Instead, the Board decided to require an approach that holds interest rates constant (i.e., the

interest rate used in the present value calculation to initially determine the liability's fair value continues to be used in subsequent measurements). In periods subsequent to the initial measurement, a company should recognize changes to the liability due to the passage of time as an increase in its carrying amount and as accretion expense in the income statement. The resulting accretion expense should not be considered as interest cost for purposes of applying FASB Statement No. 34, *Capitalization of Interest Cost*, nor classified as interest expense in the income statement.

Sometimes a company's estimate of the timing or amount of estimated cash flows associated with an exit or disposal activity changes. A company should recognize the effects of such changes as adjustments to the liability in the period of the change. Such changes should be reported in the income statement using the same line item(s) used to initially report the related costs. The company should measure these adjustments to the liability using the same credit-adjusted risk-free rate as it used to measure the liability initially. (See paragraphs 77–88 of Concepts Statement 7 for guidance on determining the credit-adjusted risk-free rate.)

Recognition and Measurement of Certain Costs

One-Time Termination Benefits

Exit or disposal costs may include termination benefits. Statement

146 applies only to those benefits provided to current employees that a company plans to terminate involuntarily under the terms of a *one-time benefit arrangement*. A one-time benefit arrangement is an arrangement that applies for a special termination event or for a specified future period. However, if a company has a history of providing similar termination benefits, there is a rebuttable presumption that an ongoing plan exists. In those situations, the company should account for the termination benefits as part of an ongoing plan under other accounting standards (generally, FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*).

A one-time benefit arrangement exists at the date a company's termination plan meets *all* of the following conditions *and* the company communicates the termination plan to its employees (referred to as the *communication date*):

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

- 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.

Statement 146 does not specifically indicate the meaning or provide additional guidance for the phrase *having the authority to approve the action*. Our Firm believes that, at a minimum, a company's chief operating decision maker should approve the plan. However, in today's operating environment, depending on the magnitude of the plan to the company, it may be more prudent to have the company's Board of Directors also approve the exit plan.

Also, Statement 146 does not specifically indicate whether the company's plan and communication to its employees should be in writing. Although it is permissible to notify the employees orally, our Firm believes that a company also should provide the notification in writing to satisfy subsequent inquiries from a company's auditor and regulators.

Statement 146 does not indicate how long a company has to complete its termination plan. Unlike the examples within EITF Issue No. 94-3 and the SEC staff commentary in Staff Accounting Bulletin (SAB) No. 100, (Topic 5-P), "Restructuring and Impairment Charges," Statement 146 does not indicate that the plan must be completed within a one-year period.

The initial recognition and measurement of a liability for one-time termination benefits rests on whether a company requires its employees to keep working until

the planned termination date and beyond a minimum retention period to receive the one-time termination benefits.

Statement 146 specifies that the company's minimum retention period is the *legal notification period*, or 60 days if the company is not required to give notification. The legal notification period is the period of time that existing law, statute, or contract requires a company to give to its employees in the event of a planned termination. If a U.S. company has 100 or more employees, the Worker Adjustment and Retraining Notification Act generally requires that a company notify its employees 60 days in advance of most planned terminations. However, a company's union or collective bargaining contracts may specify a longer notification period.

No continuing service required

A company should recognize and measure the liability for one-time termination benefits at its fair value at the communication date if: (1) employees are entitled to receive the termination benefits regardless of when they leave, or (2) the required service period does not exceed the minimum retention period. In subsequent periods, the company should account for changes in the liability as discussed above in the section regarding subsequent measurement. (See Examples 1 and 2B – Examples begin on page 7.)

Continued service required beyond minimum retention period

If employees are required to continue working to receive the termi-

nation benefits and the company will retain the employees beyond the minimum retention period, the company should initially measure the liability at the communication date based on the fair value of the liability *as of* the termination date. In these situations, the company should recognize the liability and the cost ratably as the employees render service between the communication date and the termination date.

During the service period, a company should measure a change resulting from a revision to either the timing or the amount of estimated cash flows over the remaining service period using the credit-adjusted risk-free rate that the company used to measure the liability initially. The company should recognize the cumulative effect of such change as an adjustment to the liability in the period of change. (See Examples 2 and 2A)

Subsequent to the termination date, the company should account for changes to the liability as described above in the section regarding subsequent measurement.

Changes to a plan

If a company revises its termination plan to require its employees to work after the minimum retention period, the company should adjust the liability previously recognized at the communication date to the liability that the company would have recognized had it originally applied the above guidance for required continuing service in all periods subsequent to the communication date. The company should recognize the cumulative effect of the adjustment to the liability in

the period of change. In subsequent periods, the company should apply the above guidance for continuing required service. (See Example 3)

Voluntary Terminations

Some termination plans meeting the above conditions of a one-time benefit arrangement may contain elements of both voluntary and involuntary termination benefits. In those situations, a company should account for the involuntary termination benefits in accordance with the above guidance. A company should recognize a liability for the incremental voluntary termination benefit (i.e., the amount over the involuntary termination benefit) using the guidance in Statement 88. Under Statement 88, a company that offers special termination benefits to its employee should recognize a liability and an expense when the employee accepts the offer and the company can reasonably estimate the amount of the liability. (See Example 4)

Contract Termination Costs

Costs to terminate an operating lease or other contract included in the scope of Statement 146 are those to terminate the contract before its term ends or costs that a company will continue to incur under the contract for its remaining term without economic benefit to the company.

If a company intends to terminate a contract early, it should recognize a liability for the termination costs at its fair value when the company terminates the contract in compliance with the contract terms. In other words, if the terms of the contract require written notification

of cancellation, the company should recognize and measure a liability when it gives written notification. This is a significant change from the consensus positions reached in EITF Issue No. 94-3. The EITF did not provide guidance on how the liability should be measured and required a company to recognize a liability at the commitment date for an exit plan even if nothing was communicated to the other party until later.

In periods subsequent to contract cancellation, the company should follow the guidance in the section above regarding subsequent measurement.

In accounting for costs that will continue to be incurred without economic benefit, a company should recognize and measure a liability at its fair value at the point it ceases to use the right conveyed under the contract terms (the *cease-use date*). The most common example is the right to use property under an operating lease. For an operating lease, a company should determine the fair value of the liability at the cease-use date based on the remaining rental payments (adjusted for the effects of any prepaid or deferred items the company recognized under the lease), less an amount estimated for sublease rentals that the company could reasonably obtain for the property, even if it is not the intent of the company to sublease. However, a company should not reduce the remaining lease payments to an amount less than zero. In periods subsequent to the cease-use date, the company should account for adjustments in the liability as dis-

cussed in the section above regarding subsequent measurement. (See Example 5)

Once again, this represents a significant change from the commitment-date approach utilized in EITF Issue No. 94-3. It is also a change from the consensus positions reached in EITF Issue No. 88-10, *Cost Associated with Lease Modification of Termination*. Although recognition of a liability under EITF Issue No. 88-10 is similar to a cease-use approach, EITF Issue No. 88-10 does not require a fair value measurement and permits, but does not require, discounting.

Other Associated Costs

A company should recognize and measure, at fair value, a liability for other costs associated with an exit or disposal activity (such as costs to consolidate or close facilities and relocate employees) in the period in which it incurs a liability to others (generally, when goods or services associated with the activity are received). Statement 146 prohibits a company from recognizing a liability before it is incurred, even if the cost is directly related to an exit plan and is incremental to other operating costs. This is a significant change from the commitment date approach utilized in EITF Issue No. 94-3. Statement 146 also requires a company to recognize future operating losses expected to be incurred in connection with an exit or disposal activity in the period(s) in which they are incurred.

Reporting

A company should include costs associated with an exit or disposal

activity that does not involve a discontinued operation in income from continuing operations before income taxes in the income statement. In addition, if a company presents a subtotal such as *income from operations*, it should include the exit or disposal activity cost within that caption. When the costs are associated with discontinued operations, as discussed in Statement 144, the amounts should be classified as such.

A company should reverse a liability if an event or circumstance occurs that discharges or removes its responsibility. Statement 146 specifies that the company reverse the related costs through the same line item in the income statement where the costs were recognized initially.

Disclosures

Statement 146 requires a company to disclose the following information in the notes to the financial statements that include the period in which a company initiates an exit or disposal activity and any subsequent periods until the activity is completed:

- A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date
- For each major type of cost associated with the activity (for example, one-time termination benefits, contract termination costs, and other associated costs):
 - 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

- 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)
- The line item(s) in the income statement or the statement of activities in which the costs in the second bullet point above are aggregated
- 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)
- If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reason(s).

Required Disclosures for SEC Reporting Companies

SEC registrants should also comply with the MD&A disclosure requirements in Item 303 of Regulation S-K and the guidance in SAB 100. SAB 100 stresses the need to disclose information about exit or disposal activities as soon as it is known by management, to provide meaningful disclosure about the expected impact of these events on a company's future earnings and

cash flows, and subsequently to discuss differences between projected amounts and actual costs incurred. The SAB states, "The ... economic or other events that cause a registrant to consider and/or adopt an exit plan or that impair the carrying amount of assets, generally occur over time. Accordingly, ... as those events and the resulting trends and uncertainties evolve, they often will meet the requirement for disclosure pursuant to the Commission's MD&A rules prior to the period in which the exit costs and liabilities are recorded pursuant to GAAP." Since Statement 146 delays the recognition of costs associated with exit and disposal activities until the liabilities for those costs are incurred, we expect that companies will more frequently need to provide disclosure about these events in MD&A before the related costs are reflected in the financial statements.

In addition, an SEC registrant should disclose the potential effects of adopting Statement 146 in its filings with the SEC for periods subsequent to June 30, 2002, unless the impact on the financial Statements is not expected to be material. Under SAB 74 (Topic 11M), *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*, a registrant should provide the following disclosures:

- A brief description of Statement 146
- The date the company must adopt the Statement or, if the company is eligible for early adoption, the date it plans to adopt

- The expected impact of the Statement on the reported financial position and results of operations. If a company has quantified the impact and that amount is material, the estimated amount should be disclosed. However, if the amount is immaterial or the impact is not known or reasonably estimable, a statement to that effect should be made.

Effective Date and Transition

The guidance in Statement 146 is effective on a prospective basis for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged.

A company should not restate previously issued financial statements. Statement 146 specifies that a company has initiated an exit or disposal activity when its management, having the authority to approve the plan, commits to an exit or disposal activity or otherwise disposes of a long-lived asset (disposal group) and, if the activity involves the termination of its employees, the company has met the above conditions for a plan of termination. A company should continue to apply the provisions of EITF Issue No. 94-3, including its disclosure requirements, for an exit activity initiated under an exit plan that met the conditions of EITF Issue No. 94-3 prior to the effective date of Statement 146.

If you would like to obtain more information on the new Statement and the services BDO can provide, please contact your BDO engagement partner, or for non-clients, please contact our Director of Financial Reporting, Frank Scheuerell, at (212) 885-8194 or our National Director of Accounting, Benjamin Neuhausen, at (312) 616-4661.

Example 1 No Continuing Service Required

On September 15, 2002, the Board of Directors of GCS Generator Company approved a plan to cease operations at its Bath, Maine facility and to terminate all 160 employees currently working at that location. It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. On September 30, 2002, GCS management, via e-mail, communicated to its employees the details of the plan indicating that all 160 employees at the Bath facility will be terminated in 90 days. The Company will pay \$7,500 to each employee on December 31, 2002, as a termination benefit. No future service is required to receive the termina-

tion benefit (i.e., an employee who is terminated receives the \$7,500 even if the employee stops working immediately upon notice of termination). The communication also was posted in various locations around the Company's operating facilities. GCS should recognize a liability at September 30 (the communication date) and measure it at its fair value. The Company's credit-adjusted risk-free rate is 8.75%. In this situation, GCS should recognize a liability of \$1,174,106 (\$1.2 million (160 x \$7,500) discounted at 8.75% for 90 days). GCS should recognize accretion expense in the period from September 30, 2002 through December 31, 2002.

Example 2 Continuing Service Required Beyond Minimum Retention Period

On June 15, 2003, the Board of Directors of GCS Generator Company approved a one-time benefit arrangement as part of a plan to close its Bath, Maine facility. It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. GCS management communicated details of the plan to its employees on June 30, 2003, indicating that the Company will be closing its operations in Bath, Maine in 18 months (on December 31, 2004) and that its remaining employees will be terminated at that time. The Bath location has 160 employees at the communication date. In an effort to keep as many of its employees as possible until the location actually closes, the Company is offering a cash payment of \$10,000, payable six months after the termination date, if an employee stays until December 31, 2004. An employee is not eligible for the termination benefit if he or she leaves before the Bath operations close.

At June 30, 2003 (the communication date), GCS should estimate the fair value of the termination benefit as of December 31, 2004 (the termination date). In this example, GCS estimates the liability for the termination benefit at June 30, 2003 using an expected present value technique. First, GCS estimates the expected cash flows that will be paid on June 30, 2005, taking into consideration the likelihood that some employees will leave voluntarily before the facility is shut down. GCS estimates that 20 employees will leave voluntarily prior to the termination date. Thus, the expected cash outflow at June 30, 2005 is \$1.4 million ((160-20 employees) x \$10,000 per employee). GCS next determines the present value of \$1.4 million to be paid at June 30, 2005 as of December 31, 2004 (the termination date) using its credit-adjusted risk-free rate. The Company determines that its credit-adjusted risk-free rate is 8.75%. As a result of the present value calculation, the fair value of the liability as of December 31, 2004 is \$1,340,283, which GCS will recog-

nize ratably at \$74,460 ($\$1,340,283/18$) each month during the 18-month service period from June 30, 2003 through December 31, 2004. GCS should recognize accretion expense after the termination date until the obligation is settled on June 30, 2005.

Assume that on December 31, 2003 (6 months after the communication date), GCS determines that 45 employees have already left voluntarily, 25 more than previously expected. Assume further that the Company now estimates an additional 15 employees will leave before the termination date. In an attempt to induce the remaining employees to stay until December 31, 2004 (the termination date), GCS communicates to the remaining employees that it will increase the termination benefit to \$12,000 and reduce the payout period from 6 months to 4 months. As a result of these changes to the estimated cash flows, GCS should adjust its liability for the termination benefit. Taking into account the current revisions, the estimated future cash flows are \$1.2 million (\$12,000 per employee x 100 employees) to be paid April 30, 2005 (4 months after the termination date). Statement 146 requires that GCS use the credit-adjusted risk-free rate used in the initial calculation, in this case 8.75%. As a result, the adjusted fair value of the liability as of the termination date is \$1,165,628. The adjusted liability at December 31, 2003 should be \$388,543 ($\$1,165,628/18 \times 6$). The amount that GCS has recognized based on the original estimate of fair value is \$446,760. As a result, at December 31, 2003, GCS should reduce the recognized liability by \$58,217. GCS should report the adjustment in the same line(s) in the income statement that the original amounts were reported. Assuming no further changes, GCS should accrue \$64,757 ($\$1,165,628/18$) per month from January 1, 2004 until December 31, 2004. GCS should recognize accretion expense during the four months from the termination date to the payment date.

Example 2A

Continuing Service Required

On September 15, 2002, the Board of Directors of GCS Generator Company approved a plan to streamline operations at its Bath, Maine facility and to terminate 160 of the 1,000 employees currently working at that location. It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. On September 30, 2002, GCS management, via e-mail, communicated to employees its intention to downsize operations at the Bath facility. The e-mail indicated that 160 plant workers would be terminated in 90 days and that the Company will pay \$7,500 to each employee involuntarily terminated. The communication also was posted in various locations around the Company's operating facilities. Although there is no explicit requirement for continued service, the communication implies that an

employee who voluntarily leaves during the next 90 days will not be entitled to the separation bonus. As there is no contractual notification period, the minimum retention period is 60 days. At September 30, 2002, GCS should estimate the termination benefit payable at December 31, 2002 and recognize it ratably over the 90 days. GCS estimates that 20 employees will voluntarily leave before December 31, 2002. In this situation, GCS should recognize a liability of \$1,050,000 ((160-20) employees x \$7,500 per employee) at the rate of \$350,000 per month over the implied service period. There is no need to discount the cash flows because the termination benefit will be paid out on the last day the employees complete the service requirement (December 31, 2002).

Example 2B

Continuing Service Required for the Minimum Retention Period

Assume the same facts as Example 2A, except that the 1,000 employees currently working at the Bath facility belong to a union. The union contract requires the Company to notify its union employees 90 days in advance of any planned termination.

In this case, at September 30, 2002 (the communication date), GCS should estimate and recognize, at fair value, the termination benefit payable at December 31, 2002. Although GCS requires its employees to keep working until December 31, 2002 (the termination date),

this date is not beyond the minimum retention period under the union contract.

GCS estimates that 20 employees will voluntarily leave before December 31, 2002. Thus, on September 30, 2002, GCS should immediately recognize a liability of \$1,027,362 ((160-20) employees x \$7,500 per employee) discounted at 8.75% for 90 days.) GCS should recognize accretion expense during the three months from the communication date to the payment date.

Example 3 Plan Changes

Assume the same facts as Example 1; however, on November 30, 2002, 60 days after the communication date, the company decides that it will keep the plant operating until May 31, 2003. As a result, GCS changes its original termination plan to require that an employee must work until the plant closes or is otherwise terminated to receive the termination benefit. The Company will pay the benefit on September 30, 2003, four months after the termination date. To simplify the calculations, assume that no employees left during the first 60 days and the estimated benefit is still \$1.2 million. The service period is now eight months, the initial three months, plus the additional five months the plant will remain open. In this example, the Company should follow the same steps in Example 2 above to determine the adjusted liability at the original communication date based on the fair value as of the termination date. The Company should make the calculations as if the plan revisions were in place since the original plan's inception. The total estimated future cash flows are still \$1.2

million. However, in measuring the liability's fair value, GCS should estimate the number of employees that will voluntarily leave before the termination date. In this case assume 20 people will leave early. GCS reduces the estimated future cash flows to \$1,050,000. The Company should next determine the present value of \$1,050,000 to be paid September 30, 2003, four months after the termination date, using its credit-adjusted risk-free rate. The Company determines that its credit-adjusted risk-free rate is 8.75%. As a result, the fair value of the liability as of the termination date is \$1,019,925 ($(160 - 20) \times \$7,500$ discounted at 8.75% for 4 months). GCS should accrue \$127,491 ($\$1,019,925/8$) per month during the 8-month service period. Thus, the adjusted liability at November 30, 2002 is \$254,982. As a result, GCS will adjust the recognized liability to \$254,982 using the same line item used to initially recognize the liability. GCS should recognize accretion expense during the four months from the termination date (June 1, 2003) to the payment date (September 30, 2003).

Example 4 Voluntary Benefits

Assume the GCS Generator Company has developed a one-time benefit arrangement under a termination plan that meets the conditions of Statement 146 which has been communicated to its employees. The termination plan indicates that GCS intends to eliminate 125 employees from its operations in Boca Raton, Florida. The plan contains elements of both voluntary and involuntary termination benefits. The plan indicates that up to 125 employees that voluntarily leave within 30 days will receive \$12,000 upon separation. However, if the Company needs to terminate employees involuntarily to reach the target of 125 employees, those employees will be paid only \$7,500 upon termination. Management believes that all 125 employees will leave during the

minimum retention period. The Company's credit-adjusted risk-free rate is 8.75%.

In this situation, GCS should recognize, at the communication date, a liability for the involuntary portion of the termination benefit, which should be measured at fair value. However, because of the short discount period, the liability's fair value as of the termination date may not be materially different than the amount of the involuntary portion of the termination benefit, which is \$937,500 ($\$7,500 \times 125 = \$937,500$). The Company should recognize a liability for the incremental \$4,500 ($\$12,000 - \$7,500$) per employee voluntary portion of the benefit when the employees accept the offer (i.e., in accordance with Statement 88).

Example 5 Lease Termination

In January 2003, GCS Generator Company commits to a plan to close its operating facilities in Bath, Maine. As a result, GCS will no longer need the off-site warehouse that it is renting under a non-cancelable operating lease. The lease requires annual payments of \$150,000 until December 31, 2008. GCS plans to operate the facility until December 31, 2003 (the cease-use date). However, for comparative reasons, GCS does not intend to sublease the property. At December 31, 2003 (and not before), GCS should recognize a liability for the costs it will continue to incur under the lease without economic benefit. The liability should be measured at fair value at that date. To estimate the fair value at December 31, 2003, GCS should reduce the remaining lease payments by estimated sublease payments that GCS could reasonably obtain for the property. At December 31, 2003 (the cease-use date), GCS believes, based on then current market conditions, it could sublease the warehouse for \$135,000 per year. Thus, the expected net cash flows are \$75,000 $((\$150,000 - \$135,000) \times 5)$. GCS has determined that its credit-adjusted risk-free rate is 8.75%. As a result, the fair value of the liability at December 31, 2003 (the

cease-use date) is \$58,725. This amount should be recognized as an expense at that date. GCS should recognize accretion expense after the cease-use date and GCS also should recognize in each of the next five years an expense of \$135,000 for the impact of not subleasing the warehouse.

Assume that on December 31, 2004, GCS decides to sublease the warehouse and signs a sublease agreement. Under this sublease agreement, GCS will receive \$130,000 per year for the remaining lease term of 4 years for a total of \$520,000 over the remaining lease term. As a result, the revised net cash flows are \$80,000 $(\$600,000 \text{ (remaining rental payment)} - \$520,000)$. Thus, to determine the adjusted fair value of the liability at the sublease date, GCS would discount the \$80,000 over the remaining term of the lease using its initial credit-adjusted risk-free rate of 8.75%. This would result in an adjusted liability of \$65,152. Accordingly, GCS should adjust the carrying amount of the liability at December 31, 2004 to \$65,152. GCS should continue to recognize accretion expense after the sublease date.

Material discussed in this *Financial Reporting* newsletter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.