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ACCOUNTING FOR TERMINATION INDEMNITIES

Introduction

1. Termination indemnities (also called termination allowances, severance indemnities, or related terms) are amounts payable to employees on termination of their employment. Payment of termination indemnities may be required by law, required by contract, or made as a matter of custom. Termination indemnities are an important feature of social legislation in many countries, and the circumstances determining both the right to payment and the amount of payment vary from country to country.

Scope of this Statement

2. This statement is intended to provide guidance on accounting for termination indemnity plans by enterprises that present financial statements prepared in conformity with accounting principles generally accepted in the United States ("U.S. GAAP"). The enterprises most commonly affected include:

- U.S. enterprises with branch operations in foreign countries,
- U.S. enterprises consolidating or combining foreign affiliates or accounting for foreign investments under the equity method, and
- Foreign enterprises reporting in conformity with U.S. GAAP.

Although termination indemnity plans most commonly affect operations in foreign countries, the provisions of this statement are also appropriate for similar plans in the U.S. This statement does not apply to isolated termination agreements negotiated with individual employees.

3. This statement does not address the appropriate accounting for pensions. Accounting for pensions is described in Accounting Principles Board Opinion 8, and is also on the current agenda of the Financial Accounting Standards Board. Termination indemnities may be viewed as compensation for the voluntary or involuntary loss of employment. Accordingly, termination indemnities are fixed amounts paid at termination either in a lump sum or, occasionally, in a few payments over a short period of time. By contrast, a pension is generally a series of systematic payments made over the remaining life of the employee.

PROVISIONS OF TERMINATION INDEMNITY PLANS

4. As used in this statement, "termination indemnity plan" means any set of circumstances that gives rise to termination indemnity payments, whether established by legal requirements, by labor agreements, or by custom. The provisions of termination indemnity plans vary considerably and affect the accounting for termination indemnities.

Basis for Paying Termination Indemnities

5. In some countries, the law requires payment of termination

indemnities to virtually all employees, no matter what the cause of their termination. In other countries, however, the payment of termination indemnities is required only in certain circumstances. The practices of a particular country may involve one or more of the factors discussed in paragraphs 6-11.

6. Just Cause. "Just cause," as specified by law or labor agreement, is often a factor in determining whether termination indemnities must be paid. If just cause is a factor, payment of termination indemnities is usually required when an employee is discharged without just cause and, in some countries, quits with just cause. Just cause for discharging generally includes acts by the employee such as theft, violence to the employer or the employer's property, unjustified absence, and gross negligence. Just cause for quitting generally includes acts by the employer such as providing unsafe working conditions and failing to pay wages. In many countries, quitting is always considered to be for just cause.

7. In some countries the courts apply the law in such a way that termination indemnities are rarely denied, even though the law distinguishes between just and unjust causes for termination.

8. Retirement. In some countries, termination indemnities are paid on the retirement of an employee irrespective of pensions. In other countries, rights to termination indemnities may affect the amounts to be paid as pensions to retiring employees, and the plan must be analyzed to determine the portion of the payment to be accounted for as termination indemnities and the

portion to be accounted for as pensions.

9. Death. In some countries, termination indemnities are payable on the death of an employee.

10. Notice. In some countries, an employee may forfeit a termination indemnity by quitting without giving the employer a specified advance notice, or the employer can avoid paying a termination indemnity by giving the employee a specified advance notice of discharge. However, in the latter case, if the employee is relieved of normal duties during the period of notice, in substance, the termination indemnity is not avoided.

11. Definite Term of Employment. In some countries, employees hired for a definite period of time may be entitled to termination indemnities.

Basis for Determining Amount of Payment

12. The amount of the termination indemnity to be paid is generally based on a formula involving the employee's wage rate (generally the rate in effect at termination) and length of employment. Often the employee must complete a qualifying period of service to be entitled to receive a termination indemnity.

13. The reason for the termination may also affect the amount of the termination indemnity. For example, an employee discharged without just cause may be entitled to a larger indemnity than an employee discharged with just cause. In such cases, it may appropriate to consider the excess amount separately as a contingency. In some countries, special provisions apply for

large-scale terminations such as those resulting from plant closings.[1]

ACCOUNTING TREATMENT

14. The substance of some termination indemnity plans may be such that eventual payment of termination indemnities to present employees is a certainty, and, accordingly, termination indemnities should be accrued currently. In contrast the future payment of indemnities to present employees under other plans may involve a contingency and, depending on the circumstances, may or may not require accrual or disclosure. Financial Accounting Standards Board Statement No. 5 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain...or loss...to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur."[2] Although FASB Statement No. 5 specifically excludes from consideration "employment-related costs,"[3] the principles of that statement provide a suitable basis to serve as guides to the accounting for certain termination indemnity plans.

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[1] The accounting treatment for termination indemnities resulting from the disposal of a segment of a business is described in Accounting Principles Board Opinion 30. The measurement principles of Opinion 30 are also appropriate for calculating gains or losses resulting from disposal of a portion of a business that does not meet the criteria of a segment of a business. (See the interpretation to APB Opinion No. 30 issued November 1973.)

[2] Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies, March, 1975, paragraph 1.

[3] FASB Statement No. 5, paragraph 7.

15. The appropriate accounting for termination indemnities depends on the provisions of the plan. A particular termination indemnity plan may involve a combination of the factors described in paragraphs 6-11, and the appropriate accounting may involve a combination of the methods described below.

Termination Indemnities Not Involving Contingencies

16. Plans Requiring Indemnities for All Terminations. If termination indemnities are paid for virtually all terminations, whether by discharge, quitting, death, or retirement, the liability for termination indemnities involves no contingency since there is no uncertainty that a liability has been incurred--all present employees will eventually terminate and be entitled to receive indemnities.

17. The estimated liability for those termination indemnities should be accrued currently. The amount of the accrued liability is the estimated amount of the indemnities that is attributable to the employees' service up to the date of the financial statements. That amount should, if practicable, be determined as the discounted present value of the estimated future payments that are attributable to the employees' service up to the date of the financial statements. When it is not practicable to determine the timing of the future payments and the future wage rates on which they will be based, the accrued liability is equivalent to the amount that would be paid had all employees terminated on the date of the financial statements.

18. Plans Requiring Termination Indemnities for Definite Terms of Employment. In some countries, employees hired for a definite term of employment or for a particular project are entitled to receive termination indemnities. Examples are some construction projects. Unless evidence indicates that the employees will not complete their specified employment terms, the liability for termination indemnities should not be considered a contingency since there is no uncertainty that a liability has been incurred--the employees who complete the term of employment will be terminated and be entitled to receive indemnities. In estimating the liability, consideration should be given to the possibility that some employees may not complete the term of employment and not be entitled to termination indemnities.

19. For termination indemnities payable to employees hired for a definite term of employment, the liability to be accrued is the portion of the total estimated amount of the indemnities that will be paid on termination that is attributable to the employees' service up to the date of the financial statements. For indemnities payable on completion of a definite term of employment, the accrued liability should, if practicable, be determined as the discounted present value of the estimated future payments that are attributable to the employees' service up to date of the financial statements. Discounting this liability may be appropriate because for a definite term of employment the timing of the future payments may be determinable, and

it may also be possible to estimate the future wage rates on which the amount of the future payments and, thus, the discounted amount of the liability will be based. If termination indemnities are or may be payable to employees who are terminated before the completion of the definite term of employment, those indemnities should be accounted for in accordance with paragraph 17 or 22, whichever applies.

Termination Indemnities Involving Contingencies

20. In some countries, terminated employees are entitled to termination indemnities (or indemnities in excess of the amount generally paid all terminated employees) only in certain specified circumstances. Since the payment of termination indemnities depends on the occurrence of an uncertain future event, the payment involves a contingency.

21. As discussed in paragraph 14, the principles of FASB Statement No. 5 provide suitable guidance for accounting for termination indemnities involving contingencies. Paragraph 8 of that statement requires the accrual of an estimated liability for a loss contingency if both of two conditions are met:

1) Information available prior to the issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

2) The amount can be reasonably estimated.

22. If the two conditions of the preceding paragraph are met, the estimated liability for termination indemnities should be accrued. The amount of the accrued liability is the estimated amount of the indemnities that is attributable to the employees' service up to the date of the financial statements. That amount should, if practicable, be determined as the discounted present value of the estimated future payments that are attributable to the employees' service up to the date of the financial statements. When it is not practicable to determine the timing of the future payments and the future wage rates on which they will be based, the accrued liability is equivalent to the amount that would be paid had all employees terminated on the date of the financial statements.

Disclosure

23. If termination indemnities constituting a contingency are not accrued (or only partially accrued) because one or both of the conditions in paragraph 21 are not met, the contingency should be disclosed if there is at least a reasonable possibility that a termination indemnity or an additional termination indemnity may have been incurred. The disclosure should indicate the nature of the contingency and give an estimate of the possible monetary exposure or state that such an estimate cannot be made.

Income Statement Treatment of Termination Indemnities

24. Since the amount of termination indemnities is usually based on the employees' lengths of service and wage rates, a liability for termination indemnities generally increases over time as the employees' lengths of service and wage rates increase. A liability for termination indemnities also increases when:

- The conditions of paragraph 21 are met for the first time for a group of employees.
- A termination indemnity plan is adopted.
- A termination indemnity plan is amended to increase the amounts that must be paid terminated employees.

25. Charges arising from increases in accruals for termination indemnities should ordinarily be treated as payroll costs. Accordingly, they should be reported currently as expenses except to the extent that it is appropriate to include payroll costs in the cost of an asset (for example, inventories). No future benefit to the employer is associated with increases in accruals for termination indemnities that result because (1) the conditions of paragraph 21 are met for the first time, (2) a termination indemnity plan is introduced by government action, or (3) a termination indemnity plan is amended by government action to increase the indemnities. Therefore, the charge arising from such increases in the accrual should be reported as a current expense.

26. When an enterprise enters into a contract (for example, a labor union contract) that increases the indemnities to which employees are entitled on termination, a portion of the resulting increase in the accrual for termination indemnities can be considered to be an element of payroll costs during the term of the contract. Accordingly, it is appropriate to defer such an increase to the extent that it (1) relates to the effect on the accrual of termination indemnities attributable to the employees' service performed before the beginning of the contract and (2) results from the introduction or amendment of a termination indemity plan, and amortize it over the term of the contract. Also, if a contract provides for higher wages or salaries that are to be in effect for two or more periods, it is appropriate to defer and amortize over such periods the increase in the liability for termination indemnities that results from the combined effect of the higher wages or salaries and the employees' service performed before the beginning of the contract.

Classification of the Liability for Termination Indemnities in the Balance Sheet

27. The accrued liability for termination indemnities should be classified in the balance sheet as a long-term or short-term liability as appropriate. Amounts expected to be paid within a relatively short period of time, usually one year, should be classified as a short term liability.[4]

[4] Accounting Research Bulletin no. 43, chapter 3A.

Effect on Interperiod Allocation of Income Taxes

28. Consideration should be given to the effect of the accrual of termination indemnities on the interperiod allocation of income taxes. For example, timing differences will arise if termination indemnities are wholly or partly deductible in determinging taxable income when the indemnities are paid rather than when they are accrued.

Transition

29. This statement should be applied for financial statements for fiscal years beginning after ________________ and for interim periods within those fiscal years. The provisions of this statement should, to the extent practicable, be applied retroactively. If retroactive application is adopted, financial statements for earlier periods should be restated to conform to the provisions of this statement. If financial statements for all periods presented are restated, the cumulative effect of applying this statement on retained earnings at the beginning of the earliest period presented should be included as an adjustment of retained earnings of that period. If financial statements of one or more periods presented are not restated, the cumulative effect of applying this statement on retained earnings of the earliest period restated should be included in determining net income of that period.[6] In a period in which the cumulative effect is included in deter-

[6] See paragraph 20 of APB Opinion 20, "Accounting Changes." Pro forma disclosure required by paragraphs 19(d) and 21 of APB Opinion 20 are not applicable.

mining net income, the cumulative effect should be disclosed, and the reason for not restating the prior periods presented should be given.

APPENDIX

ILLUSTRATIONS OF THE APPLICATION OF THIS STATEMENT

The following illustrations are intended to demonstrate the application of the provisions of this statement. The illustrations are meant to describe common features or circumstances of a number of termination indemnity plans, but they are not meant to represent the laws or customs of a particular country. The ability to make estimates and determinations such as those described in the illustrations and the appropriate accounting for a particular termination indemnity plan depend on an evaluation of the facts of each particular case.

Example A: Termination Indemnities Paid to All Employees

Situation: The labor laws of a country require the payment of termination indemnities for all terminations except for discharging an employee for just cause. However, the law's specification of "just cause" is vague, and the company has a policy of paying indemnities to all employees rather than contesting such matters in court.

Accounting Treatment: Since termination indemnities will be paid to virtually all employees, the liability for termination indemnities should be accrued in accordance with paragraph 17.

Since the company cannot estimate the dates on which the termination indeminities will be made nor the wage rates on which they will be based, the amount of the accumulated accrued liability at the financial statement date is equivalent to the amount of the termination indemnities that would be paid had all employees terminated at the financial statement date.

Example B: Termination Indemnities Paid to All Employees with Double Indemnities Paid in Certain Circumstances

Situation: The labor laws of a country require the payment of termination indemnities to all employees regardless of the reason for termination, but employees who are discharged without just cause are entitled to receive double indemnities. "Just cause" has been clearly established by law and its application over the years.

Accounting Treatment: Since all employees will be entitled to at least single benefits, the liability for that amount should be accrued in accordance with paragraph 17.

Any additional payment for double indemnities depends on the future event that employees will be discharged without just cause. This payment therefore involves a contingency and the related liability should be accrued if both conditions of paragraph 21 are met.

The company has no present plans to discharge employees and has determined that it is not probable that employees will be discharged without just cause. Since the first condition of paragraph 21 has not been met, the contingency resulting from double indemnities should not be accrued as a liability.

Example C: Termination Indemnities Not Paid to Employees Quitting without Giving Notice

Situation: A company ordinarily pays termination indemnities regardless of the reason for termination, but the company does not pay indemnities to employees who quit without giving notice and intends to continue this policy. However, it is not reasonable to expect that employees would forfeit their termination indemnities by quitting without giving notice.

Accounting Treatment: Since the company will pay termination indemnities to virtually all employees, the company should accrue the liability for termination indemnities in accordance with paragraph 17.

Example D: Definite Term of Employment - Employment Contract

Situation: An enterprise is party to a number of similar employment contracts that provide for termination indemnities. One contract is for a period of five years beginning January 1, 19x1 and requires the enterprise to pay the employee a termination indemnity of $100,000 at the end of that term. There is no reason to believe the employees will not fulfill the contract.

Accounting Treatment: The termination indemnity relates to a definite term of employment. The liability for the termination indemnity should therefore be accrued in accordance with paragraphs 18-19. Because it is possible to determine the amount of the future payment ($100,000) and the timing of the payment (December 31, 19x5), the liability should be discounted for future interest. Assuming the imputed interest rate is 8%, the amount of the accrued liability for termination indemnities and termination indemnity and interest expense at each balance sheet date is as follows:

		Financial Statement Date				
		12/31/x1	12/31/x2	12/31/x3	12/31/x4	12/31/x5
(a)	Portion of Termination Indemnity Attributable to Completed Periods of Employment	$20,000	$40,000	$60,000	$80,000	$100,000
(b)	Accrued Liability for Termination Indemnity	17,046	35,455	55,337	76,810	100,000
(c)	Increase in Liability (Additions to (b))	17,046	18,409	19,882	21,473	23,190
(d)	Interest Expense	-0-	1,363	2,836	4,427	6,144
(e)	Termination Indemnity Expense	17,046	17,046	17,046	17,046	17,046

Example E: Definite Term of Employment - Construction Project

Situation: A company has undertaken a major construction project that will take three years to complete. At the completion of the project, the construction workers will be dismissed.

The labor laws of the country require the payment of termination indemnities to employees who are terminated without just cause. Because the completion of the construction project is not considered just cause, the employees who will be terminated will be entitled to indemnities. Employees terminated for reasons other than discharging without just cause are not entitled to termination indemnities. The amount of the indemnities is one month's wages for each completed year of employment.

Accounting Treatment: Since termination indemnities will be paid at the end of a definite term of employment, the resulting liability should be accrued in accordance with paragraphs 18 and 19.

At the end of the first year of the project, 300 workers are employed. The company estimates that of the 300 employees, 200 have been employed for one year and will continue to be employed until the completion of the project at which time they will be entitled to termination indemnities. The company also estimates that 60 of its remaining employees, who average one-half year's service each, will continue to be employed until the completion of the project, when they will be entitled to termination indemnities. The average monthly wage at the end of the first year is $600, and the average monthly wage at the end of the third year is expected to be $700.

In this illustration the liability is discounted for future interest at an imputed interest rate of 10%. The company calculates the accrued liability for termination at the end of the first year as follows:

(a)	Estimated years of service of employees who will be entitled to receive termination indemnities (200 plus 1/2x60)	230
(b)	Average accrued termination indemnity for each year of service per employee (one month's wages at rate on termination for each year of employment)	\$700
(c)	Total indemnity attributable to completed period of service (aXb)	\$161,000
(d)	Accrued liability for termination indemnitites (present value of (c) at 10%)	\$133,050
(e)	Termination indemnity expense	\$133,050

A liability for termination indemnities arising from discharging employees without just cause before the completion of the project involves a contingency. If both conditions of paragraph 21 are met, the contingency should be accrued. In this case, the company does not expect to terminate any employees without just cause before the completion of the project; thus the first condition of paragraph 21 is not met, and no liability is accrued.

Example F: Company with Policy of Discharging Certain Employees Who Are Not Promoted

Situation: The labor laws of a country require the payment of termination indemnities to employees who are discharged without just cause. A company has a policy of discharging certain employees who fail to be promoted. The employees who are discharged under this policy are entitled to termination indemnities. The company is able to make reasonable estimates of the termination indemnities resulting from its policy.

Accounting Treatment: Since the termination indemnities are payable only for discharging without just cause, the liability involves a contingency. The liability should be accrued if both conditions of paragraph 21 are met.

The company's termination policy makes it probable that certain present employees will be entitled to termination indemnities, and the company can reasonably estimate the amount. Therefore, the liability resulting from the company's policy is accrued.

The company must also consider the possibility that termination indemnities will be paid to other employees who are discharged without just cause, for example, discharged for incompetence or in a reduction of the workforce. The company presently has no intention of discharging other employees without just cause, and the amount of any related liability cannot be reasonably estimated. Therefore that contingency is not accrued.

Example G: Termination Indemnities Paid to Retiring Employees

Situation: The labor laws of a country require the payment of termination indemnities to employees who are discharged without just cause. The law sets no mandatory retirement age, but a company has a policy of retiring employees who reach the age of 68. The law considers such mandatory retirements as discharges without just cause, and the retiring employees will be entitled to termination indemnities in addition to any pensions they may receive.

Accounting Treatment: Since the termination indemnities are payable only for discharge without just cause, the liability for termination indemnities involves a contingency. The liability should be accrued if both conditions of paragraph 21 are met.

The company has determined that because of its policy of retiring employees at age 68, it is probable that certain present employees will be paid termination indemnities. The company can reasonably estimate the amount of the resulting liability. Thus, both conditions of paragraph 21 are met, and the company will accrue the liability for termination indemnities for retiring employees.

It may be possible for the company to estimate the timing of the payments to retiring employees and the future wage rates on which the payments will be based. If so, it would be appropriate to accrue the liability based on the discounted present value of the payments.

Example H: Termination Indemnities Resulting from Reduction in Operations

Situation: The labor laws of a country require that termination indemnities be paid only to employees discharged without just cause. During the next year, a company plans to reduce its operations in the country and discharge a number of employees. The law considers the terminations to be without just cause.

Accounting Treatment: Because the indemnities are paid only in specific circumstances, the liability for termination indemnities involves a contingency and should be accrued if both conditions of paragraph 21 are met.

As soon as the company decided to reduce its operations and discharge certain employees, it became probable that a liability had been incurred. The company can reasonably estimate the amount of the liability. Thus, both conditions of paragraph 21 are met, and the company will accrue the liability for termination indemnities. Since the indemnities will be paid in the next period, the liability should be classified as current.