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Accounting for time paid not worked; Issues paper (1979 January 11)

American Institute of Certified Public Accountants. Task Force on Time Paid Not Worked

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ACCOUNTING FOR TIME PAID NOT WORKED

Introduction

1. Many companies make payments to employees that compensate them for other than time worked. The payments often are for periods of absence from employment, such as for vacations, sick days, holidays, and jury duty. Other payments are made on separation of employment (severance pay, termination indemnities) or during post separation periods, such as the continuation of life and medical insurance benefits. Some post separation payments are made to, or on behalf of, individuals other than the employee, such as a spouse or other dependent.
2. The degree of formality of the arrangements providing for payments other than for time worked varies considerably. The payments may be required by law or by contract, as in the case of a collective bargaining agreement, they may be established by company policy, or they may be made to certain employees solely at the discretion of management or the owners of the business.
3. The accounting treatment for payments other than for time worked varies in practice. Two methods are currently

followed:

(a) the expense is accrued over some period of time before payment or (b) the payments are charged to expense when paid. There may be variations of these methods found in current practice. No authoritative accounting literature specifically covers this subject (see paragraph 13).

4. Because of the diversity of practice and the lack of authoritative guidance for the subject, the accounting standards division recommends that the FASB consider the subject. An analysis of the scope of this project and the specific issues involved follows.

Scope

Types of Payments

5. The issues raised in this paper are intended to cover a broad range of payments made to , or on behalf of, employees that are, in themselves, not directly conditioned on job attendance at that time. Included are amounts paid before, on, or after termination of employment. The key characteristic common to all these situations is that there will be a future payment to or on behalf of an employee without additional job related services being rendered at that time.

6. Payments to, or on behalf of, employees that are covered by existing authoritative accounting literature are excluded from the scope of this paper. Existing pronouncements deal with accounting for pensions (APB Opinion 3), deferred compensation (APB Opinion 12), and stock issued to employees (APB Opinion 25). However, the considerations involved in determining the accounting practices for those costs, especially pensions, may also be applicable to accounting for payments other than for time worked, as mentioned in paragraph 7 of FASB Statement No. 5, "Accounting for Contingencies:"

Accounting for other employment-related costs, such as group insurance, vacation pay, workmen's compensation, and disability benefits, is also excluded from the scope of this Statement. Accounting practices for those types of costs and pension accounting practices tend to involve similar considerations.

The types of benefits covered by this paper are discussed further in a later section.

7. The issues paper, "Accounting for Termination Indemnities," prepared by the AICPA International Practice Technical Subcommittee, was sent to the FASB on December 12, 1978 for consideration by its Screening Committee on Emerging Problems. The paper discusses accounting for termination

indemnity plans of enterprises that present financial statements in conformity with U.S. GAAP and suggests factors under which plan liabilities should be accrued or disclosed as a contingency. The Accounting Standards Executive Committee believes that since the issues contained in "Accounting for Termination Indemnities" are similar to those in this issues paper, the FASB should consider the two papers together.

Financial Statements and Entities Covered

8. The issues involved in accounting for payments other than for time worked should be evaluated within the context of financial statements prepared in conformity with generally accepted accounting principles.

9. Accounting in interim financial statements is presently covered by APB Opinion 28; however, the FASB is currently reconsidering the conclusions of that pronouncement. An interesting sidelight is contained in a reference in APB Opinion 28, paragraph 15, to the annual accounting treatment for vacation pay:

Charges are made to income for all other costs and expenses in annual reporting periods based upon (a) direct expenditures made in the period (salaries and wages), (b) accruals for estimated expenditures to be made at a later date (vacation pay) or (c) amortization of expenditures that affect more than one annual period (insurance premiums, interest,

rents). The objective in all cases is to achieve a fair measure of results of operations for the annual period and to present fairly the financial position at the end of the annual period. (Emphasis added.)

The above reference seems to indicate a presumption by the Accounting Principles Board that vacation pay is accrued in annual financial statements.

10. The Cost Accounting Standards Board has addressed the accounting for certain types of payments covered by this paper. Cost Accounting Standard No. 408, "Compensated Personal Absence," deals specifically with accounting for vacation and sick pay, among other things. Section 408.40 of the Standard provides for the accrual of the costs of compensated personal absence over the "periods in which the entitlement was earned." It is possible that the cost accounting considerations applicable to payments other than for time worked may differ from financial accounting considerations to which the scope of this project is restricted.

Balance Sheet Focus

11. The effect on annual income of accounting for payments other than for time worked is probably not significant for most entities, except in a year in which a company changes to a policy of accruing vacation pay or similar liabilities. Thus the main concern of this paper is the effects of the

payments on the balance sheet and the potential for unrecorded or understated liabilities. Because of the increasing size of many entities' (and industries') "fringe benefit" packages, the potential for significant liability understatement exists. The balance sheet effect is a concern especially in connection with purchases and sales of companies and when entities are near violation of loan agreements based on debt to equity ratios, working capital requirements, etc.

Current Literature

12. As previously mentioned, there is no comprehensive discussion in current authoritative literature of the subject of payments other than for time worked. However, the following pronouncements may be relevant to the topic:
 - A. CASB Standard No. 408, "Compensated Personal Absence" (previously discussed).
 - B. SOP 75-3, "Accrual of Revenues and Expenditures by State and Local Governmental Units" -- favors disclosure over balance sheet accrual for vacation and sick pay for such units.
 - C. FASB Statement No. 5, "Accounting for Contingencies," -- as previously discussed, the Statement exempts employment related costs.
 - D. APB Opinion 8, "Accounting for the Cost of Pension Plans," -- deals only with pension costs.
 - E. AICPA International Practice Technical Subcommittee's issues paper, "Accounting for Termination Indemnities," --

would require the accounting to follow the terms of the plan or the laws or customs of a particular country and would generally require accrual of a liability equivalent to the amount that would be paid had all employees terminated on the date of the financial statements.

F. SEC Staff Accounting Bulletin (Topic 5 (c)) states:

Facts: Company B discloses its accrued vacation pay in a footnote to its financial statements.

Question: Should accrued vacation pay be recorded in the financial statements?

Interpretative response: The staff believes that accrued vacation pay should be recorded in the financial statements.

- G. APB Opinion 16, "Business Combinations," -- paragraph 88 discusses valuation of the liability for vacation pay at the date of acquisition under purchase accounting.
- H. APB Opinion 28, "Interim Financial Reporting," (previously discussed).
- I. APB Opinion 30, "Reporting Results of Operations," -- paragraph 17 discusses accrual of severance pay in the disposal of a segment of a business.
- J. Appendix A of APB Opinion 11, "Accounting for Income Taxes," paragraph (B) -- states that expenses for vacation and severance pay "are recorded in accounts

when accrued for the applicable period and deducted in tax returns when later paid."

Types of Payments

13. As previously mentioned, the issues involved in payments other than for time worked cover many different types of payments. Although it is difficult to generalize, the division believes that there are two primary distinguishing characteristics around which the various payments can be grouped: (a) the manner in which the payment is earned and (b) the arrangement under which the payment is made.
14. Payments for other than time worked can be classified by the manner in which the payment is earned as follows:

Accumulatable Pre-termination Benefits - Benefits are conditioned on being employed over a period of time. Benefits accumulate under such arrangements. Accumulation includes both prorata payments to individuals on termination of employment and carryovers by individuals of benefits to succeeding years. Examples of benefits that are often accumulatable are vacation, sick days, holidays, and compensatory time off (but not normal overtime payments in cash).

Nonaccumulatable Pre-termination Benefits - are conditioned on being employed at a point in time. There is no accumulation or carryover of benefits. Examples of benefits that are often nonaccumulatable are early

closing, jury duty, voting, military training, death in the family, rest periods, coffee breaks, and wash up time.

Severance Pay and Other Termination Benefits - Benefits

are conditioned on being employed over a period of time and are paid pending, at the time, or after termination of employment. This group can be subdivided into

(1) severance pay (including termination indemnities) and (2) post separation benefits, such as continuation of life or medical insurance. See International Practice Technical Standards Subcommittee issues paper, "Accounting for Termination Indemnities," December 12, 1978.

Severance pay is distinguished from the other categories of payments other than for time worked since it is precipitated by an act of management, whereas the benefits other than severance are generally precipitated by the action of the employee, for example, taking a vacation, being absent due to illness, or quitting.

15. The nature of the benefit itself is more important than what it is called for the purpose of classification in the groups above. For example, if a severance pay plan is "automatic," such as if an employee earns one week of severance pay for every year employed and will receive it regardless of the form of termination, the plan probably falls under the first type above. If an employee has no right to carry-over

holidays, the benefit would be nonaccumulatable and would fall under the second type above.

16. The second distinguishing characteristic of payments other than for time worked is the nature of the arrangement or plan by which the benefit is established. These arrangements can be classified as follows:

Established by Law or Contract - Under this type of arrangement, a legal or contractual obligation to pay the benefit exists. An example is vacation pay that is fixed by union contract and payable directly by the employer.

Established by Entity Policy - No legal or contractual obligation to provide the benefit exists, but the entity has established a policy to pay. These arrangements include both (1) plans that are in writing and formally communicated to the employees and (2) plans that are the custom of the entity based on practice over a period of time though they are not in writing.

Informal or Discretionary - These payments do not conform to a regular pattern. An example is discretionary termination payments made to only certain employees.

Issues

17. The issues involved in accounting for payments other than for time worked can be grouped under four headings, (a) timing of cost recognition, (b) measurement of cost,

(c) application, and (d) transition, as follows:

18. Timing of Cost Recognition

- A. Should all payments covered by the issues paper be recorded when paid or should some or all be accrued in advance of payments?
- B. If some of the benefits should not be recorded when paid, which of them should be accrued in advance of payment?
 - 1. Is the manner in which the payment is earned (accumulatable, nonaccumulatable, or others) a pertinent factor in determining the need for accrual?
 - 2. Is the nature of the arrangement under which the payment is made (legal, company policy, or informal) a pertinent factor?
 - 3. How should benefits be determined and accrued for plans that are "the custom of the entity based on practice?"
- C. Over what periods should the accrual for the benefits in issue B above be recorded?
- D. Should there be specific rules for new or amended plans? For example, should newly granted benefits that may be based on past service be expensed in full as they are added or should the effect be spread over a period that is estimated to benefit from the employees' continued or past service?

1. If the effect is to be spread, should the gross liability be accrued with a portion allocated to deferred charges until expensed or should only the amount to be expensed currently be accrued?

19. Measurement of Cost

- A. Should the liability be based on the rate of pay or cost of other benefits at the time the benefit is earned or the anticipated cost at the time the payment will be made?
- B. Should other actuarial assumptions be made? Examples of actuarial assumptions are:
 1. Employee decisions to not avail themselves of covered benefits (for example, forfeiture of earned vacation).
 2. Employee termination before the benefits are provided, resulting in lost benefits.
 3. Employee mortality rates for post retirement benefits.
 4. Increased future employee benefits such as scheduled increases in the number of vacation weeks according to length of employment.
- C. Should future payments be presented at their discounted amounts? If so, should that be done for all benefits or limited to only some, such as:
 1. Payments fixed as to date and amount.
 2. Payments that would be classified as noncurrent.
- D. Should the amount to be accrued be affected by the manner in which the benefit can be paid, such as compensatory

time off or additional cash payments?

1. If the amount to be accrued is affected by compensatory time off, should a factor be whether a worker needs to be hired to replace the individual who takes time off?

E. Are there additional cost recognition problems arising from an employee working during periods he or she would have been permitted to be absent and thus accumulating benefits to be provided in the future? (For example, if an employee does not take a vacation in a given fiscal year.)

1. Should costs be determined differently for salaried versus hourly employees working during periods he or she would have been permitted to be absent?

F. Should an entity's vesting policy have an effect on the accounting policy for payments other than for time worked, such as a limitation on the number of days that can be accrued but not taken?

G. Should there be materiality or other guidelines to exempt entities from accruing the amounts? To what extent should the entities provide note disclosure of amounts not accrued?

20. Application

A decision would have to be made as to whether the accounting provisions of a final pronouncement on the subject apply only to commercial enterprises or both commercial enterprises and nonbusiness organizations. Some believe

accrual by governmental units of all payments covered by the issues paper may not be appropriate because governmental units can only expend what is budgeted and usually cannot authorize an operating budget for more than one year. Therefore, vacation or sick leave earned but not taken is not considered an expense of that year. However, the unit may have the liability regardless of whether money to pay it has been budgeted.

21. Transition

- A. If a previously unrecorded liability is recognized, should it be accounted for by retroactive adjustment, by cumulative catch-up, or prospectively?

Advisory Conclusions

22. The following are the conclusions of the Accounting Standards Executive Committee on certain basic issues contained in paragraphs 18 and 21:

- AcSEC members voted (13 yes, 0 no) that benefits under accumulatable plans based on law or entity policy should be accrued and expensed as earned because the amounts represent liabilities and the only reason not to accrue is that the amounts are often immaterial. Also, as a general rule, benefits under non-accumulatable plans should be expensed as paid.

- AcSEC members voted (12 yes, 0 no) that a change in accounting principles to adopt the provisions of a final pronouncement on this subject should be accounted for as a retroactive adjustment.

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January 11, 1979

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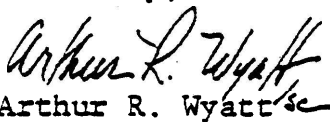
Dear J. T.:

Enclosed are fifteen copies of an issues paper, "Accounting for Time Paid Not Worked," for consideration by the Screening Committee on Emerging Problems.

The paper was prepared by the Task Force on Time Paid Not Worked and approved by the Accounting Standards Executive Committee.

Representatives of the division are available to discuss this paper with you or your representatives at your convenience. The division would appreciate being advised on the committee's proposed actions on the issues set forth in this paper.

Sincerely,



Arthur R. Wyatt
Chairman
Accounting Standards Executive Committee

ARW:hjs
Enclosure

cc: Accounting Standards Executive Committee (File 4430)
Task Force on Time Paid Not Worked