

Financial reporting developments  
*A comprehensive guide*

# Exit or disposal cost obligations

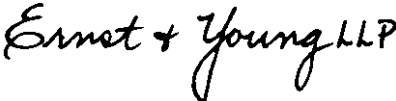
August 2023

# To our clients and other friends

Accounting Standards Codification (ASC) 420, *Exit or Disposal Cost Obligations*, addresses the financial accounting and reporting for costs associated with exit or disposal activities. Costs associated with an exit or disposal activity that are covered by ASC 420 include, but are not limited to, one-time involuntary termination benefits and certain contract termination costs.

This publication summarizes the accounting literature on accounting for exit or disposal activities, provides our interpretive guidance and reflects our experience in practice with ASC 420.

We hope this publication will help you understand and apply the accounting for exit or disposal activities. EY professionals are prepared to assist you in your understanding and are ready to discuss your particular concerns and questions.

The logo for Ernst & Young LLP is written in a black, cursive script. The words "Ernst & Young" are connected together, and "LLP" is written in a smaller font size to the right.

August 2023

# Contents

<b>1</b>	<b>Overview (updated April 2022)</b> .....	<b>1</b>
1.1	One-time termination benefits .....	1
1.2	Certain contract termination costs .....	2
1.3	Other associated costs .....	2
<b>2</b>	<b>Scope</b> .....	<b>3</b>
2.1	Exit activities .....	5
2.2	Disposal activities .....	5
2.3	Restructuring in a business combination .....	6
<b>3</b>	<b>Recognition and measurement</b> .....	<b>7</b>
3.1	Recognition (updated April 2022) .....	7
3.2	Initial measurement .....	8
3.2.1	Fair value .....	8
3.2.1.1	Overview of ASC 820 .....	9
3.2.1.2	Effect of ASC 820 on ASC 420 .....	10
3.2.1.3	Market risk premium .....	10
3.2.1.4	Credit-adjusted risk-free rate .....	11
3.2.1.5	Credit-adjusted risk-free rate consideration for a subsidiary .....	12
3.3	Subsequent measurement .....	12
<b>4</b>	<b>One-time termination benefits</b> .....	<b>13</b>
4.1	Criteria for recognizing a one-time benefit arrangement .....	14
4.2	One-time vs. ongoing benefit arrangements .....	14
4.2.1	Other factors to consider when determining whether an ongoing benefit arrangement exists .....	16
4.2.2	Summary of accounting under ASC 712 .....	17
4.3	Timing of recognition and measurement of one-time benefit arrangements .....	18
4.3.1	Future service not required .....	18
4.3.2	Future service required .....	19
4.3.3	Minimum retention period exception (updated August 2023) .....	20
4.4	Fair value considerations .....	21
4.5	Subsequent measurement .....	21
4.6	Voluntary and involuntary termination benefits .....	23
4.7	Interaction with other accounting pronouncements .....	24
4.7.1	ASC 715 .....	24
4.7.2	ASC 712 .....	25
4.7.3	ASC 710 .....	25
<b>5</b>	<b>Contract termination costs</b> .....	<b>26</b>
5.1	Costs to terminate a contract .....	26
5.1.1	Fair value considerations .....	27
5.2	Costs that will continue to be incurred under a contract .....	27
5.2.1	Cease-use date .....	27

5.2.2	Impairment of an unrecognized asset .....	27
5.2.3	Initial measurement .....	28
5.2.4	Fair value considerations .....	28
5.2.5	Subsequent measurement .....	28
<b>6</b>	<b>Other associated costs .....</b>	<b>29</b>
<b>7</b>	<b>Presentation and disclosure .....</b>	<b>30</b>
7.1	Presentation.....	30
7.2	Disclosure .....	33
<b>A</b>	<b>Abbreviations used in this publication .....</b>	<b>A-1</b>
<b>B</b>	<b>Glossary .....</b>	<b>B-1</b>
<b>C</b>	<b>Index of ASC references in this publication .....</b>	<b>C-1</b>
<b>D</b>	<b>Summary of important changes .....</b>	<b>D-1</b>

**Notice to readers:**

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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# 1 Overview (updated April 2022)

ASC 420 establishes an accounting model for costs associated with exit or disposal activities, including restructuring activities. Under this model, a liability for costs associated with an exit or disposal activity should be recognized and initially measured at fair value only when it is incurred (i.e., when the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6), is met).

It is important to distinguish between costs that are in the scope of ASC 420 and those that are not in the scope of the guidance. These costs include, but are not limited to, the following:

Costs covered by ASC 420	Costs not covered by ASC 420
Employee termination benefits under a one-time arrangement	Employee termination benefits under an ongoing arrangement (ASC 712 or ASC 715) or a deferred compensation contract (ASC 710)
Costs to terminate a contract that is not a lease	Costs to terminate a contract that is a lease
Other costs associated with exit and disposal activities, including costs to consolidate or close facilities and relocate employees	Costs associated with the retirement of a long-lived asset in the scope of Subtopic 410-20
	Impairment of long-lived assets (ASC 360-10)



## Standard setting

In November 2019, the FASB proposed removing the reference to CON 6 from ASC 420 and including the guidance from CON 6 in ASC 420-10-25-2. In addition, the FASB proposed clarifying that financial instruments that are liabilities under ASC 480 are in the scope of ASC 420. Based on comment letter feedback, the FASB plans to issue a revised proposal.

In December 2021, the FASB issued Concepts Statement No. 8, *Conceptual Framework for Financial Reporting* (CON 8), that superseded CON 6. However, the Board did not remove the reference to CON 6 from ASC 420-10-25-2. We do not believe the FASB intended to change how a liability for costs associated with an exit or disposal activity should be recognized and initially measured. Because the FASB previously proposed adding the language from CON 6 to ASC 420, we believe the guidance in CON 6 should still be applied.

## 1.1 One-time termination benefits

A one-time benefit arrangement is deemed to exist at the date the plan of termination meets certain criteria and has been communicated to employees (hereinafter referred to as the communication date). Further, the timing for recognizing a liability and the amount of liability recognized is dependent on whether employees are required to render future service in order to receive the termination benefits. If employees are required to render service until they are terminated and that service period extends beyond a “minimum retention period,” the liability (expense) should be recognized ratably over the future service period, even if the benefit formula used to calculate the termination benefit is based on past service.

## 1.2 **Certain contract termination costs**

Contract termination costs in the scope of ASC 420 include (1) costs to terminate a contract before the end of its term (excluding leases within the scope of ASC 842) and (2) costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity. Liabilities for these costs are to be recognized and measured at fair value in the period in which the liability is incurred (generally when the entity terminates the contract pursuant to the contractual terms or ceases to use the rights conveyed under the contract).

## 1.3 **Other associated costs**

A liability (expense) for other costs associated with exit or disposal activities, such as costs to consolidate or close a facility, should be recognized and measured at fair value in the period in which the liability is incurred (generally upon receipt of the goods or services (e.g., security services incurred during the closing of the facility)), not at a commitment date.

# 2

## Scope

### Excerpt from Accounting Standards Codification

#### Exit or Disposal Cost Obligations – Overall

##### *Overview and Background*

##### **420-10-05-1**

The Exit or Disposal Cost Obligations Topic addresses financial accounting and reporting for costs associated with exit or disposal activities. An exit activity includes but is not limited to a **restructuring**.

##### **420-10-05-2**

Those costs include, but are not limited to, the following:

- a. Involuntary employee termination benefits pursuant to a one-time benefit arrangement that, in substance, is not an ongoing benefit arrangement or an individual deferred compensation contract
- b. Costs to terminate a contract that is not a **lease**
- c. Other associated costs, including costs to consolidate or close facilities and relocate employees.

##### **420-10-05-3**

This Topic addresses when to recognize a liability for a cost associated with an exit or disposal activity. An entity's commitment to an exit or disposal plan, by itself, does not create a present obligation to others that meets the definition of a liability.

##### **420-10-05-4**

Certain postemployment benefit costs that may be associated with exit or disposal activities are covered by other Topics. The accounting for employee termination benefits will differ depending on whether the benefits are provided under a one-time benefit arrangement covered by this Topic or an ongoing benefit arrangement referred to in the following list. As indicated in paragraph 420-10-15-6, this Topic does not change the accounting for termination benefits covered by the following Topics and Subtopics:

- a. Postemployment benefits provided through a pension or postretirement benefit plan (Subtopics 715-30 and 715-60 specify the accounting for those costs.)
- b. Other nonretirement postemployment benefits covered by Topic 712
- c. Special or contractual termination benefits covered by paragraphs 715-30-25-10 and 715-60-25-4 through 25-6
- d. Individual deferred compensation arrangements that are addressed by paragraph 710-10-15-4(c)
- e. Stock compensation plans addressed by Topic 718.

##### *Objectives*

##### **420-10-10-1**

The objective of the Exit or Disposal Cost Obligations Topic is to improve financial reporting by requiring that a liability for a cost associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred.



## **Scope and Scope Exceptions**

### **Entities**

#### **420-10-15-2**

The guidance in the Exit or Disposal Cost Obligations Topic applies to all entities.

### **Transactions**

#### **420-10-15-3**

The guidance in the Exit or Disposal Cost Obligations Topic applies to the following transactions and activities:

- a. Termination benefits provided to current employees that are involuntarily terminated under the terms of a benefit arrangement that, in substance, is not an ongoing benefit arrangement or an individual deferred compensation contract (referred to as **one-time employee termination benefits**)
- b. Costs to terminate a contract that is not a **lease** (see paragraphs 420-10-25-11 through 25-13 for further description of contract termination costs and paragraph 842-20-40-1 for terminations of a lease)
- c. Costs to consolidate facilities or relocate employees
- d. Costs associated with a disposal activity covered by Subtopic 205-20
- e. Costs associated with an exit activity, including exit activities associated with an entity newly acquired in a business combination or an **acquisition by a not-for-profit entity**.

#### **420-10-15-4**

An exit activity includes but is not limited to a **restructuring**, such as the sale or termination of a line of business, the closure of business activities in a particular location, the relocation of business activities from one location to another, changes in management structure, and a fundamental reorganization that affects the nature and focus of operations.

#### **420-10-15-5**

The guidance in this Topic does not apply to the following transactions and activities:

- a. Costs associated with the retirement of a long-lived asset covered by Subtopic 410-20.
- b. Impairment of an unrecognized asset while it is being used.

### **Other Considerations**

#### **420-10-15-6**

Certain postemployment benefits are covered by other Topics or Subtopics. This Topic 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:

- a. Subtopic 715-30
- b. Subtopic 715-60
- c. Topic 712, which includes guidance on accounting for special or contractual termination benefits, payable before retirement and not payable from a pension or other postretirement plan, as indicated in paragraph 712-10-15-3
- d. Topic 710, which includes guidance on accounting for individual deferred compensation arrangements
- e. Topic 718, which addresses stock compensation plans.

**420-10-15-7**

See paragraph 420-10-55-1 and Example 5 (paragraph 420-10-55-16) for guidance on determining whether an exit plan is a one-time termination benefit arrangement or an enhancement to an ongoing benefit arrangement as used in the preceding paragraph.

**420-10-15-8**

If a plan of termination that meets the criteria in paragraph 420-10-25-4 includes both involuntary termination benefits and voluntary termination benefits, then this Topic will apply to the involuntary termination benefits and paragraphs 712-10-25-1 through 25-3 will apply to the incremental voluntary termination benefits (the excess of the voluntary termination benefit amount over the involuntary termination benefit amount).

## 2.1 Exit activities

Although ASC 420 does not provide a definition of an exit activity, it specifies that an exit activity includes, but is not limited to, a restructuring. ASC 420 defines a restructuring as “a program that is planned and controlled by management, and materially changes either the scope of a business undertaken by an entity, or the manner in which that business is conducted,”<sup>1</sup> and includes:

- ▶ Sale or termination of a line of business.
- ▶ Closure of business locations in a country or region or relocation of business activities from one country or region to another.
- ▶ Changes in management structure (e.g., eliminating a layer of management).
- ▶ Fundamental reorganizations that have a material effect on the nature and focus of the entity’s operations.

The definition applies a materiality threshold to its definition of restructuring by requiring it to be a program that *materially* changes either the scope of a business or the manner in which that business is conducted. However, exit activities within the scope of ASC 420 are not limited to “restructurings,” as defined and, therefore, also include other types of activities that may not necessarily have a material effect on the scope of an entity’s business or the manner in which that business is conducted. For example, the decision to close a facility and relocate employees may not materially affect the scope of an entity’s business (the scope of the business will be unchanged) or the manner in which it is conducted (the employees will simply move to another facility), but those activities still would be within the scope of ASC 420.

## 2.2 Disposal activities

Disposal activities covered by the Impairment or Disposal of Long-Lived Assets subsections of ASC 360-10 include disposals by sale and other means (e.g., by abandonment, exchange for other assets or a group of assets, distributions to owners in a spin-off, and other forms of reorganization or liquidation). The impairment or disposal of long-lived assets subsections of ASC 360-10 apply to disposals of individual long-lived assets and groups of assets. Components of an entity that qualify as discontinued operations fall within the scope of ASC 205-20. ASC 420 does not address the accounting for costs to sell a long-lived asset or group of assets. Those costs are addressed in the measurement of the asset or group of assets to be disposed of under the Impairment or Disposal of Long-Lived Assets subsections of ASC 360-10. However, ASC 420 does apply to other costs, often incurred as part of such initiatives, including employee termination benefits under a one-time benefit plan and contract termination costs.

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<sup>1</sup> Refer to Appendix B Glossary for the definition of a restructuring in ASC 420 which is consistent with the definition in IAS 37.

## 2.3 Restructuring in a business combination

ASC 805 limits the recognition of restructuring costs in a business combination to restructuring obligations assumed from the target as of the acquisition date and does not permit the recognition of liabilities that result from actions taken by the acquirer, even if the restructuring plan is in place and completed on the acquisition date. Costs associated with restructuring or exit activities that are not obligations of the target would be accounted for separately from the business combination, generally as post-combination expenses of the combined entity when incurred in accordance with ASC 420.

We expect that it will be rare for an acquirer to recognize an assumed restructuring cost obligation in a business combination unless the obligation was incurred and recognized under ASC 420 by the acquiree before the business combination. However, the acquirer must, in any event, continue to meet the ASC 420 criteria as of the acquisition date.

Refer to our Financial reporting developments (FRD), ***Business combinations***, for further discussion.

# 3 Recognition and measurement

## 3.1 Recognition (updated April 2022)

### Excerpt from Accounting Standards Codification

#### Exit or Disposal Cost Obligations – Overall

#### *Recognition – Determining When to Recognize a Liability*

##### **420-10-25-1**

A liability for a cost associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred, except as indicated in paragraphs 420-10-25-6 and 420-10-25-9 (for a liability for **one-time employee termination benefits** that is incurred over time). In the unusual circumstance in which fair value cannot be reasonably estimated, the liability shall be recognized initially in the period in which fair value can be reasonably estimated (see paragraphs 420-10-30-1 through 30-3 for fair value measurement guidance).

##### **420-10-25-2**

A liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability included in FASB Concepts Statement No. 6, Elements of Financial Statements, is met. Only present obligations to others are liabilities under the definition. An obligation becomes a present obligation when a transaction or event occurs that leaves an entity little or no discretion to avoid the future transfer or use of assets to settle the liability. An exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the requisite past transaction or event for recognition of a liability.

##### **420-10-25-3**

This Subtopic requires that future operating losses expected to be incurred in connection with an exit or disposal activity be recognized in the period(s) in which they are incurred. Because future operating losses are the summation of individual items of revenue and expense that result from changes in assets and liabilities, those expected losses, in and of themselves, do not meet the definition of a liability.

A liability (expense) should be recognized for a cost associated with an exit or disposal activity when the liability is incurred. The FASB concluded that a liability for a cost associated with an exit or disposal activity is incurred when the definition of a liability in CON 6 is met. Although CON 6 has been superseded by CON 8, we do not believe the FASB intended to change how a liability for costs associated with an exit or disposal activity should be recognized and initially measured. CON 6, paragraph 35, defined a liability as follows:

“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.”

CON 6, paragraph 36, further required that all of the following three essential characteristics of a liability must be present to meet the definition of a liability:

- ▶ It is “a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.”
- ▶ “[T]he duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice.”

- ▶ “[T]he transaction or other event obligating the entity has already happened.”

It is important to note that “probable,” in the context of the definition of a liability, does not have the same meaning as in ASC 450-20. In the definition of a liability, “probable” refers to that which can reasonably be expected or believed based on available evidence and is intended to acknowledge that few outcomes are certain in the environment in which entities are operating. The FASB concluded that an entity’s commitment to a plan of disposal, by itself, is not sufficient to recognize a liability because it merely reflects an entity’s intended future actions and, by itself, does not create a present obligation to others for the costs expected to be incurred under the plan. An obligation becomes a present obligation when a transaction or event occurs leaving an entity little or no discretion to avoid the future transfer or use of assets to settle that obligation (i.e., when the liability is incurred).



### Standard setting

In November 2019, the FASB proposed removing the reference to CON 6 from ASC 420 and including the related guidance from CON 6 in ASC 420-10-25-2. In addition, the FASB proposed clarifying that financial instruments that are liabilities under ASC 480 are in the scope of ASC 420. Based on comment letter feedback, the FASB plans to issue a revised proposal.

In December 2021, the FASB issued CON 8 that superseded CON 6. However, the Board did not remove the reference to CON 6 from ASC 420-10-25-2. We do not believe the FASB intended to change how a liability for costs associated with an exit or disposal activity should be recognized and initially measured. Because the FASB previously proposed adding the language from CON 6 to ASC 420, we believe the guidance in CON 6 should still be applied.

## 3.2 Initial measurement

The liability initially should be recognized at fair value in the period in which it is incurred (except for certain employee termination liabilities as discussed in more detail in section 4). In the unusual circumstance in which a reasonable estimate of fair value cannot be made at the date the liability is incurred, an entity must disclose that fact and the reasons therefore. In such cases, the liability (expense) would be recognized when a reasonable estimate of fair value can be made. We believe that in the context of ASC 420, the inability to estimate fair value will be rare.

### 3.2.1 Fair value

#### Excerpt from Accounting Standards Codification

##### Exit or Disposal Cost Obligations – Overall

##### *Initial Measurement*

##### **420-10-30-1**

A liability for a cost associated with an exit or disposal activity shall be measured initially at its fair value in the period in which the liability is incurred, except as indicated in paragraphs 420-10-30-4 and 420-10-30-6 (for a liability for one-time termination benefits that is incurred over time).

##### **420-10-30-2**

Quoted market prices are the best representation of fair value. However, for many of the liabilities covered by this Subtopic, quoted market prices will not be available. Consequently, in those circumstances, fair value will be estimated using some other valuation technique. A present value technique is often the best available valuation technique with which to estimate the fair value of a liability for a cost associated with an exit or disposal activity. For a liability that has uncertainties both in timing and amount, an expected present value technique generally will be the appropriate technique.

**420-10-30-3**

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

**3.2.1.1****Overview of ASC 820**

ASC 820-10-20 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” This definition is based on fair value as an exit price and, as such, is a market-based measurement, not an entity-specific measurement. As a basis for considering market participant assumptions in fair value measurements, ASC 820-10-35-37 establishes a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity’s own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). The concept of unobservable inputs is intended to allow for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

The use of any specific valuation technique is not required by ASC 820, but it does prioritize the inputs used in the valuation techniques into three levels. They are: Level 1 – quoted market prices in active markets for identical assets or liabilities represent the best evidence of fair value and should be used as the basis for measurement, whenever available; Level 2 – quoted market prices for similar assets or liabilities in active markets, quoted market prices for identical or similar assets or liabilities in markets that are not active and other observable market data; and Level 3 – unobservable inputs which reflect the entity’s own assumptions about the assumptions market participants would use in pricing the liability, including assumptions about risk. Many of the inputs used to measure the fair value of exit or disposal cost obligations will be Level 3 inputs. A reporting entity’s assumptions should be adjusted when market participant data that is reasonably obtainable (without undue cost and effort) contradicts the entity’s own assumptions.

Three valuation approaches to measure fair value are described in ASC 820-10-35-24 through 35-27: the market approach, income approach, and cost approach. The three approaches are consistent with generally accepted valuation methodologies. All three approaches may not be applicable to all assets or liabilities. The income approach likely will be the valuation approach used to measure fair value of the liabilities within the scope of ASC 420 because market data generally will not be available. The income approach, which uses a present value technique, is described in ASC 820-10-55-3F, as follows:

The income approach converts future amounts (for example, cash flows or income and expense) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

Those valuation techniques include present value techniques; option-pricing models, such as the Black-Scholes-Merton formula or a binomial model (i.e., a lattice model), that incorporate present value techniques and reflect both the time value and the intrinsic value of an option; and the multiperiod excess earnings method, which is used to measure the fair value of certain intangible assets.

### 3.2.1.2 Effect of ASC 820 on ASC 420

The FASB acknowledges in ASC 420 that a present value technique often will be the best valuation technique to estimate the fair value of a liability for a cost associated with an exit or disposal activity. Two general methods to estimate fair value using a present value technique exist – the Discount Rate Adjustment Technique and the Expected Present Value Technique. The Discount Rate Adjustment Technique uses a single set of cash flows (whether contractual or most likely) with adjustments for:

- ▶ The expectations about possible variations in the amount or timing of those cash flows (including risk of default)
- ▶ The time value of money, represented by the risk-free rate of interest
- ▶ The price for bearing the uncertainty inherent in the asset or liability
- ▶ Other risk factors specific to the asset or liability

Under the Expected Present Value Technique, all expectations about possible cash flows are probability-weighted to determine an expected cash flow. Unlike the single most likely cash flows used in the Discount Rate Adjustment Technique, the expected cash flows used in the Expected Present Value Technique capture the variability in the timing and amount of future cash flows associated with the obligation. When an Expected Present Value Technique is used, an adjustment for systematic risk (a market risk premium) can be captured either in the discount rate or by adjusting the expected cash flow. These risk-adjusted expected cash flows represent a certainty equivalent cash flow which is discounted at a risk-free rate of interest (assuming credit risk has been captured in the expected cash flows). Alternatively, the expected cash flows (with no adjustment for systematic risk) would be discounted at the risk-free rate plus a risk premium. Additional information on how to apply both the Discount Rate Adjustment Technique and the Expected Present Value Technique can be found in the implementation guidance to ASC 820 in ASC 820-10-55. Refer to sections 21.2 and 21.3 of our FRD, *Fair value measurement*, for further discussion.

The FASB decided not to specify a requirement for either present value technique. The FASB decided that entities should determine the present value technique best suited to their specific circumstances based on the guidance in ASC 820 and ASC 420. However, the FASB notes in ASC 420-10-30-2 that the Expected Present Value Technique generally will be the most appropriate valuation technique for liabilities that have uncertainties in both the amount and timing of estimated cash flows.

In periods subsequent to the initial measurement, the liability should not be marked to market but rather be adjusted solely for revisions in the estimated timing and amount of future cash flows, using the credit-adjusted, risk-free rate that was used to measure the liability initially. Accordingly, only the initial measurement of liabilities within the scope of ASC 420 is subject to ASC 820 because the subsequent measurement is not a fair value measurement. This distinction becomes important because only assets and liabilities that are subsequently measured at fair value are subject to the fair value disclosures required by ASC 820. Refer to section 3.3 for additional information. Refer to our FRD, *Fair value measurement*, for more guidance on the application of ASC 820.

### 3.2.1.3 Market risk premium

Because fair value is a market-based measurement, not an entity-specific measurement, it should reflect the assumptions that market participants would use in pricing an asset or liability, including assumptions about risk. ASC 820-10-35-54E requires the inclusion of a risk adjustment in measuring fair value if a market participant would include one in pricing the asset or liability, even if the adjustment is difficult to determine. The exclusion of a risk premium when a market participant would assume one results in a measure that does not faithfully represent fair value. As such, the degree of difficulty in determining a risk adjustment is not a basis to exclude an adjustment from the determination of fair value under ASC 820.

### 3.2.1.4 Credit-adjusted risk-free rate

The risk-adjusted expected cash flows used to estimate the fair value of a liability associated with exit or disposal activities should be discounted using an interest rate that equates to a risk-free rate adjusted for the effect of the entity's credit standing unless risk related to the entity's credit standing is reflected in the expected cash flows. In the US, the risk-free rate is the zero-coupon rate for US Treasury instruments. The risk-free rates to be used should have maturity dates that coincide with the expected timing of the estimated cash flows required to satisfy the obligations.

While ASC 420 provides little guidance on adjusting the risk-free rate to reflect an entity's credit standing, we believe a reasonable approach is to estimate the entity's incremental borrowing rate on debt of similar maturity. The increment of that rate over the risk-free rate for debt of the same maturity would represent the adjustment for the entity's credit standing. That is, the credit-adjusted, risk-free interest rate or the "discount rate" will be the entity's incremental borrowing rate for a loan of a similar term. In determining the adjustment for the effect of its credit standing, the FASB indicates that a company should consider the effects of all terms, collateral and existing guarantees that could affect the fair value of the liability.<sup>2</sup>

As previously mentioned, the credit-adjusted, risk-free rates used in discounting estimated cash flows should be based on maturity dates that coincide with the expected timing of the estimated cash flows. In that regard, calculating the expected cash flows may involve uncertainty with regard to the timing and (or) amount of cash flow related to the exit or disposal activities. An example that demonstrates the use of the probability-weighted approach for expected cash flows with a market risk premium and a credit-adjusted risk-free interest rate follows.

#### **Illustration 3-1: Expected present value technique with a market risk premium and credit-adjusted risk free interest rate**

A cash flow of \$1,000 may be paid in 1 year, 2 years, or 3 years with probabilities of 10 percent, 60 percent, and 30 percent, respectively. The risk-free interest rate for 1 year is 5%, for 2 years is 5.25% and for 3 years is 5.5%. The credit adjustment is 4.75%. Accordingly, the discount rate for years 1, 2 and 3 is 9.75%, 10%, and 10.25%, respectively. The market risk premium is \$10. The example below shows the computation of expected cash flows in that situation.

Present value of \$1,010 paid in 1 year at 9.75% = \$ 920	
Probability 10%	\$ 92
Present value of \$1,010 paid in 2 years at 10.0% = \$ 835	
Probability 60%	\$ 501
Present value of \$1,010 paid in 3 years at 10.25% = \$ 754	
Probability 30%	<u>\$ 226</u>
Present value of expected net cash flow	<u><u>\$ 819</u></u>

Noteworthy, is that in this illustration the market risk premium was added to the expected cash flow. However, computationally, the market risk premium (as well as other assumptions regarding the cash flows) could be included as either an upward adjustment to the cash flows or a downward adjustment to the discount rate.

<sup>2</sup> ASC 410-20-55-15.



### 3.2.1.5 Credit-adjusted risk-free rate consideration for a subsidiary

Questions may arise about the appropriate rate to use in both consolidated financial statements and the separate financial statements of a subsidiary if an obligation represents a legal obligation of the subsidiary. That is, should the credit-adjusted risk-free rate reflect the credit standing of the consolidated entity, the parent entity, or the subsidiary with the legal obligation? We believe that the credit adjustment should reflect the credit standing of the legal obligor (i.e., the subsidiary in this case). However, if the company believes that the parent entity also could be held responsible for satisfying the obligation (e.g., if the parent entity guaranteed the subsidiary's performance under the obligation), the effect of that guarantee should be reflected in the required credit adjustment to the risk-free rate.

Additional considerations regarding the application of ASC 820, by type of exit or disposal cost, are discussed further below.

## 3.3 Subsequent measurement

### Excerpt from Accounting Standards Codification

#### Exit or Disposal Cost Obligations – Overall

#### *Subsequent Measurement – Changes in Estimates*

##### **420-10-35-1**

In periods subsequent to initial measurement, changes to the liability, including a change resulting from a revision to either the timing or the amount of estimated cash flows over the future service period, shall be measured using the credit-adjusted risk-free rate that was used to measure the liability initially.

##### **420-10-35-2**

The cumulative effect of a change resulting from a revision to either the timing or the amount of estimated cash flows shall be recognized as an adjustment to the liability in the period of the change.

##### **420-10-35-4**

Changes due to the passage of time shall be recognized as an increase in the carrying amount of the liability and as an expense (for example, accretion expense). Accretion expense shall not be considered interest cost for purposes of applying Subtopic 835-20.

In periods subsequent to the initial measurement of a liability for costs associated with an exit or disposal activity, the FASB decided, as indicated in paragraph B15 of the Basis for Conclusions of Statement No. 146, not to require remeasurement at fair value. As a result, the liability should not be marked to fair value on an ongoing basis but instead should be adjusted solely for revisions in the estimated timing and/or amount of future cash flows, using the credit-adjusted risk-free rate that was used to measure the liability initially. The cumulative effect of changes in the estimated timing or amounts of the future cash flows should be recognized as an adjustment to the liability in the period of change and reported in the same line item in the income statement used to initially record the expense. Changes that are due to the passage of time (the accretion of the liability) should be recognized as an increase in the carrying amount of the liability and as an expense in the income statement. Although ASC 420 does not address where to reflect the accretion expense in the income statement, it does indicate that accretion expense should not be classified as interest expense in the income statement and is not eligible for capitalization under ASC 835-20. We believe that a reasonable approach would be to include the accretion expense in the income statement line item originally used to record the expense associated with an exit or disposal activity.

A change resulting from a revision to either the timing or the amount of estimated cash flows over the future service period should be measured using the credit-adjusted risk-free rate that was used to measure the liability initially. The cumulative effect of the change should be recognized as an adjustment to the liability in the period of the change. Example 2 of ASC 420's implementation guidance at ASC 420-10-55 illustrates this situation and is included in section 4.5, *Subsequent measurement*.

# 4 One-time termination benefits

## Excerpt from Accounting Standards Codification

### Exit or Disposal Cost Obligations – Overall

#### *Recognition*

#### **420-10-25-4**

An arrangement for **one-time employee termination benefits** exists at the date the plan of termination meets all of the following criteria and has been communicated to employees (referred to as the **communication date**):

- a. Management, having the authority to approve the action, commits to a plan of termination.
- b. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.
- c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.
- d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

#### **420-10-25-5**

An entity's communication of a promise to provide one-time employee termination benefits is a promise that creates an obligation at the communication date to provide the termination benefits if employees are terminated.

#### **420-10-25-6**

The timing of recognition for one-time employee termination benefits depends on whether employees are required to render service until they are terminated in order to receive the termination benefits and, if so, whether employees will be retained to render service beyond a minimum retention period.

#### **420-10-25-7**

The minimum retention period shall not exceed the **legal notification period**, or in the absence of a legal notification requirement, 60 days. For example, in the United States, the Worker Adjustment and Retraining Notification Act, as of 2002 required entities with 100 or more employees to notify employees 60 days in advance of covered plant closings and mass layoffs, unless otherwise specified. Collective bargaining or other labor contracts may require different notification periods.

#### **420-10-25-8**

If employees are not required to render service until they are terminated in order to receive the termination benefits (that is, if employees are entitled to receive the termination benefits regardless of when they leave) or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be recognized at the communication date. For an illustration of this situation, see Example 1 (paragraph 420-10-55-2).

**420-10-25-9**

As indicated in paragraph 420-10-30-6, if employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date, and shall be recognized ratably over the future service period. For an illustration of this situation, see Example 2 (paragraph 420-10-55-4).

## 4.1 Criteria for recognizing a one-time benefit arrangement

Benefits provided under a one-time benefit arrangement include, but are not limited to, severance payments, outplacement job training, counseling and other services. A one-time benefit arrangement exists under ASC 420 at the date a plan of termination meets all of the following criteria and the benefit arrangement has been communicated to employees (communication date):

1. Management, having the requisite authority to approve the action, commits to a plan of termination. The plan must be written, and if an entity's policies require board of directors' approval, or management voluntarily seeks board of directors' approval, the appropriate level of authority needed to commit the entity would be that of the board (i.e., the board would have to approve management's written plan). Even if it is probable or virtually guaranteed that management with the authority to approve a plan of termination will commit to the plan, entities should not conclude that the plan has been committed to until the plan is formally approved.

Questions often arise as to whether a plan of termination that requires shareholder approval can be considered approved before such shareholder approval is obtained. We believe that, if an entity either elects or is required to obtain shareholder approval for such a plan, that the plan of termination would not be committed to by management until it has been approved by the shareholders (assuming management is not comprised of a majority of the shareholders).

2. The plan identifies the number of employees to be terminated, their job classifications or functions, their locations and the expected completion date. The specific employees need not be named so long as their classifications or functions and location are.
3. 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.
4. 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. ASC 420 does not specify what type of actions would indicate that significant changes will be made to a plan or that a plan will be withdrawn. However, before concluding that this criterion is met, an entity should consider whether it has a history of making significant changes to such plans. Further, this criterion is meant to ensure that entities have a sufficiently robust plan of termination at the commitment date; otherwise, one may conclude that a liability has not been incurred, because significant changes to the plan indicate that the entity has discretion to avoid the future sacrifice of assets.

## 4.2 One-time vs. ongoing benefit arrangements

It's important for an entity to determine whether termination benefits are provided under a one-time benefit arrangement pursuant to ASC 420 or under an ongoing benefit arrangement pursuant to ASC 712 because ASC 712 has certain liability recognition criteria that differ from ASC 420 (refer to section 4.2.2, *Summary of accounting under ASC 712*). ASC 420 applies only to a one-time termination benefit that is not, in substance, an enhancement to an ongoing benefit arrangement.

A one-time benefit arrangement subject to ASC 420 is an arrangement that applies for a specified termination event or for a specified future period. The implementation guidance in ASC 420-10-55-1 and 55-16 through 55-19 (see below) distinguishes between an enhancement to an ASC 712 plan and a one-time termination benefit covered by ASC 420 by focusing on the additional termination benefit provided.

### Excerpt from Accounting Standards Codification

#### Exit or Disposal Cost Obligations – Overall

#### *Implementation Guidance and Illustrations*

#### *Determining Whether a One-Time Termination Benefit Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement*

#### **420-10-55-1**

Additional termination benefits may be included within the scope of this Subtopic as follows. In order to be considered an enhancement to an ongoing benefit arrangement and, therefore, subject to the provisions of the Topics referred to in paragraphs 420-10-05-4 and 420-10-15-6, the additional termination benefits must represent a revision to the ongoing arrangement that is not limited to a specified termination event or a specified future period. Absent evidence to the contrary, an ongoing benefit arrangement is presumed to exist if an entity has a past practice of providing similar termination benefits. Otherwise, the additional termination benefits should be considered **one-time employee termination benefits** and accounted for under the provisions of this Topic. See Example 5 (paragraph 420-10-55-16) for an illustration of such a determination.

The following illustration adapted from ASC 420-10-55-16 through 55-19 provides an example of an enhancement to an ongoing benefit arrangement.

#### **Illustration 4-1: One-time benefit vs. an enhancement to an ongoing benefit arrangement**

An entity has a written involuntary termination benefit plan that is distributed to all of its employees at date of hire. The plan provides that upon an involuntary termination of employment for other than cause, each terminated employee will receive one week of severance pay for every year of service. In the current year, the entity initiates a reduction in force. In connection with that reduction in force, management decides to amend the ongoing benefit arrangement to provide an additional two weeks of severance pay for every year of service. That additional benefit applies to all employees affected by this reduction in force and all future involuntary terminations.

Based on an evaluation of the circumstances, the additional termination benefit is considered an enhancement to the ongoing termination benefit plan because it represents a revision to the ongoing plan that applies to all future involuntary terminations. That is, the amendment to the ongoing benefit arrangement is not limited to a specified termination event or specified future period. Therefore, the additional termination benefit should be accounted for in accordance with ASC 712, which requires that a liability for certain termination benefits provided under an ongoing benefit arrangement be recognized when the likelihood of future settlement is probable, as that term is used in ASC 450. Thus, termination benefits that, based on the benefit formula, are attributable to past service may be recognized initially at a plan date if at that date it becomes probable that employees will be terminated and receive termination benefits under the benefit arrangement (the benefit arrangement having been communicated to employees previously, for example, at the date of hire).

If this Illustration were changed to indicate that the additional termination benefits only applied to the employees affected by that reduction in force and similar benefits had not been provided for a past reduction in force, those additional benefits would not be considered an enhancement to the ongoing termination benefit plan and would, therefore, be accounted for under the guidance in ASC 420. The severance, equal to one week of pay for each year of service, would be accounted for under ASC 712, and the additional termination benefit (two weeks of severance pay for each year of service) would be accounted for under ASC 420. This may result in the severance under ASC 712 being recorded in a different period than that covered by ASC 420.

## 4.2.1 Other factors to consider when determining whether an ongoing benefit arrangement exists

As discussed above, an enhancement to an ongoing benefit arrangement is accounted for in accordance with the applicable authoritative literature governing that ongoing arrangement (e.g., ASC 715 or ASC 712). That requirement places added emphasis on the need to determine whether an ongoing benefit arrangement exists, particularly in the absence of a written policy regarding involuntary termination benefits. Although Illustration 4-1, above, helps to determine whether a termination benefit should be accounted for under ASC 420, we believe that one of the characteristics of an ongoing benefit arrangement is the fact that benefits can be determined or estimated in advance from either the provisions of a document or from an entity's past practices or both. Accordingly, we believe that the following factors also should be taken into consideration to determine whether an ongoing benefit arrangement exists:

- ▶ The frequency and regularity with which an entity has provided termination benefits related to exit or disposal activities in the past. Consistent with that concept, ASC 420-10-55-1 above states, "absent evidence to the contrary, an ongoing benefit arrangement is presumed to exist if an entity has a past practice of providing similar termination benefits."
- ▶ The similarity of the benefits to be provided under the current plan of termination with termination benefits provided under prior termination plans. For example, consideration should be given to, among other factors, the type of benefits provided (e.g., severance payments, outplacement job training), the benefit formula used, or the form of payment (e.g., lump-sum payments, monthly payments).
- ▶ The existence of statutorily required minimum benefits to be provided in the event of involuntary termination or severance benefits documented in an employee manual or labor contract.

Consider the following illustrations.

### **Illustration 4-2: Presumed ongoing benefit arrangement – historic practice**

Company A does not have a written severance policy for any of its employees. Company A has not had a reduction in its workforce since February 2008, at which time employees who were terminated received two weeks of severance pay for each year of service upon termination. In January 2011, Company A announced a reduction in force pursuant to a properly executed plan of termination. All employees to be terminated received two weeks of severance pay for each year of service when terminated. In February 2012, Company A announced another reduction in force and provided all employees with two weeks of severance pay for each year of service when terminated. Furthermore, between February 2008 and January 2011, Company A terminated various individual employees and paid these employees the same benefits (i.e., two weeks of severance pay for each year of service). Based on the past history of providing involuntary termination benefits of two weeks of severance pay for each year of service, Company A has effectively established an ongoing benefit arrangement that would be accounted for under ASC 712 as opposed to ASC 420.

Illustration 4-2 above is not intended to provide a bright line for determining the existence of an ongoing benefit arrangement. It does, however, demonstrate that, in the absence of a formally documented ASC 712 plan, an ongoing plan effectively may be established through a history of providing related benefits.

**Illustration 4-3: Presumed ongoing benefit arrangement – statutory termination indemnities**

An entity has a restructuring plan to exit its European operations. As part of this plan, the company will close two manufacturing facilities that will result in 500 employees being terminated. The benefits to be paid represent involuntary termination benefits paid pursuant to the terms of statutory termination indemnities. In accordance with ASC 712, the company accrued the statutory termination benefits at the time management determined it was probable that benefits would be paid and the amount was reasonably estimable. That is, the statutory benefit represents an ongoing benefit arrangement. Additional benefits that may be paid pursuant to negotiations with a works council should be evaluated to determine whether those additional benefits are one-time termination benefits subject to ASC 420 or an enhancement to the ongoing arrangement and, therefore, subject to ASC 712 (part of an ongoing plan to be accrued when the benefit is reasonably estimable and probable of payment).

**4.2.2****Summary of accounting under ASC 712**

As discussed previously, accounting for termination benefits under ASC 712 may result in a difference in how and when related liabilities are recognized when compared to the accounting under ASC 420 described in this document. Termination benefits discussed in this section exclude special termination benefits and contractual termination benefits (see section 4.6). Termination benefits covered under ASC 712 include, but are not limited to, salary continuation, supplemental unemployment benefits, severance benefits, disability-related benefits (including workers' compensation), job training and counseling, and continuation of benefits such as health care benefits and life insurance coverage. ASC 712 requires employers to accrue a liability for the cost to provide termination benefits over the employees' service period if all the following conditions in ASC 710 are met:

- ▶ The obligation is attributable to employees' services already rendered.
- ▶ The obligation relates to an employees' rights to benefits that accumulate<sup>3</sup> or vest. Benefits that accumulate represent earned but unused rights that may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward. For benefits that vest, the employer has an obligation to make payment even if an employee terminates and, therefore, an employee's right to those benefits is not contingent on the employee's future service.
- ▶ Payment of the benefits is probable.
- ▶ The amount of the benefits can be reasonably estimated.

If all of these four conditions are not met, the employer should accrue a liability for termination benefits that are within the scope of ASC 712 when it is probable that a liability has been incurred and the amount can be reasonably estimated in accordance with ASC 450-20. If an obligation for postemployment benefits is not accrued in accordance with ASC 450-20 or ASC 710 only because the amount cannot be reasonably estimated, the financial statements should disclose that fact.

In summary, ASC 712 requires a liability for certain termination benefits under an ongoing benefit arrangement to be recognized when the likelihood of future payment is probable (based on how the term *probable* is used in ASC 450-20) and the amount of the related benefits are reasonably estimable.

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<sup>3</sup> In the case of an employer-provided benefit that increases each year as an employee's salary increases, the benefit might appear to accumulate. As noted in ASC 712 a benefit does not accumulate if the benefit increase is attributed solely to an increase in salary. For example, a termination benefit of one week's salary would not accumulate even though the amount generally would increase as the employee's tenure increased. However, a severance benefit of one week's salary for each year of service would accumulate because the benefit increase is attributable to the employee's length of service.

Accordingly, benefits attributable to prior services based on the benefit formula are recognized at the date the plan is introduced if it is probable that the employees will receive the benefit and the amount is reasonably estimable. The communication date is considered the date of hire assuming the plan was documented in the employee manual handed to the employee on the hire date. Another important element of the accounting for an ASC 712 plan is that ASC 712 permits, but does not require, benefits to be discounted.

### 4.3 Timing of recognition and measurement of one-time benefit arrangements

#### Excerpt from Accounting Standards Codification

##### Exit or Disposal Cost Obligations – Overall

##### *Initial Measurement*

##### **420-10-30-4**

The timing of measurement of a liability for **one-time employee termination benefits** depends on whether employees are required to render service until they are terminated in order to receive the termination benefits and, if so, whether employees will be retained to render service beyond a minimum retention period.

##### **420-10-30-5**

If employees are not required to render service until they are terminated in order to receive the termination benefits (that is, if employees are entitled to receive the termination benefits regardless of when they leave) or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured at its fair value at the **communication date**. Example 1 (paragraph 420-10-55-2) illustrates the application of this paragraph.

##### **420-10-30-6**

If employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date. For an illustration of this situation, see Example 2 (paragraph 420-10-55-4).

When the FASB originally deliberated Statement 146 (codified in ASC 420), it concluded that the benefit formula should not serve as the basis for determining whether future services of an employee are required. Instead, the determination of whether employees are required to render future service should be based solely on when employees are entitled to receive the termination benefits, and other facts and circumstances should not be considered. In that regard, the FASB indicated in paragraph B26 of the Basis for Conclusions of Statement 146 that an entity would not communicate a promise to provide one-time termination benefits before actual termination unless the entity had a need for the employee to render future service. However, ASC 420 provides for a minimum retention period, as discussed below, that does not constitute future service.

#### 4.3.1 Future service not required

If employees are not required to render service until they are terminated in order to receive the termination benefits (i.e., if employees are entitled to receive the termination benefits regardless of when they leave) or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits should be recognized and measured at its fair value at the communication date (i.e., when all communication date requirements have been met in accordance with ASC 420-10-25-4). The following illustration was adapted from ASC 420-10-55-2 and 55-3.

**Illustration 4-4: One-time termination benefits – no future service required**

An entity has a one-time benefit arrangement established by a plan of termination that meets the criteria in ASC 420-10-25-4 and has been communicated to employees. The entity plans to cease operations in a particular location and determines that it no longer needs the 100 employees that currently work in that location. The entity notifies the employees that they will be terminated in 90 days. Each employee will receive as a termination benefit a cash payment of \$6,000, which will be paid at the date an employee ceases rendering service during the 90-day period.

A liability would be recognized at the communication date and measured at its fair value. In this case, because of the short discount period (i.e., up to a maximum of 90 days), \$600,000 (100 employees x \$6,000 per employee) may **not** be materially different from the fair value of the liability at the communication date. In addition to the short discount period, there is no uncertainty as to the amount of the eventual cash payment (\$600,000), although there may be some uncertainty with respect to the timing since employees may collect the benefits at any time over the next 90 days. Accordingly, the effect of a market risk premium would likely not be material in this example.

## 4.3.2

**Future service required**

If employees are required to render service (beyond a minimum retention period) until they are terminated in order to receive the termination benefits, the liability should be measured initially at the communication date based on its fair value as of the termination date and recognized ratably over the future service period. The liability then would be accreted from the termination date to the payment date. Even if a benefit formula is based on past service, the liability (expense) for the one-time termination benefits is not automatically recognized at the communication date under ASC 420. Consider the following illustration and see Example 2 from ASC 420 in section 4.5, *Subsequent measurement*.

**Illustration 4-5: One-time termination benefits – future service required**

Company Z implements a plan to shut down its US west coast operations. As a result, 99 employees will be terminated. On 1 January 20X1, Company Z has a formalized and appropriately approved plan of termination that identifies the employees that will be terminated along with the amount of severance each employee will receive and their anticipated date of termination. On 31 January 20X1, Company Z establishes a communication date by communicating to the employee group that each involuntarily terminated employee will receive \$1,000 under the one-time termination plan that will be paid upon termination. An employee that leaves voluntarily before the facility is shut down will not be entitled to receive any portion of the termination benefit. An equal number of employees will be terminated in each of three stages during 20X1; the first will be on 30 June, the second on 31 July and the third on 31 August.

The liability measured on the communication date (31 January 20X1) and based on the fair value of the liability as of the respective termination dates, is \$99,000 (assuming the effects of discounting and interest premiums are immaterial). In this situation, since the employees are required to render future services, Company Z will record the liability (expense) ratably over the service period. For example, the monthly expense through 30 June and the amount accrued as of 30 June would be as follows:

	Monthly expense		Accrual as of 30 June
June terminations	\$ 33,000/5	\$ 6,600	\$ 33,000
July terminations	33,000/6	5,500	27,500 <sup>(a)</sup>
August terminations	33,000/7	4,714	23,571 <sup>(b)</sup>
		<u>\$ 16,814</u>	<u>\$ 84,071</u>

(a) 5,500 x 5 months (February through June) = 27,500

(b) 4,714 x 5 months (February through June) = 23,570



Immaterial differences may arise in the recomputation of amounts in the example above due to rounding.

**Note:** Because the payment occurs upon termination, the liability is not accreted. Refer to Example 2 from ASC 420 in section 4.5, *Subsequent measurement*, for an example that illustrates accretion of the liability to be paid in periods following the termination date.

### 4.3.3

#### Minimum retention period exception (updated August 2023)

During the deliberations of Statement 146 (codified in ASC 420), the FASB concluded that an entity might have to communicate a promise to provide one-time termination benefits in advance of termination for reasons other than the need for employees to render future service (e.g., existing law or legal contracts may require an entity to provide advance notification to employees regarding their termination).

As a result, ASC 420 requires recognition of the liability at the communication date, provided that employees are not required to render service beyond a minimum retention period. The minimum retention period is defined as and should not exceed the legal notification period or, in the absence of a legal notification requirement, 60 days. The legal notification period either refers to an existing law, statute or contract (e.g., in the U.S., the Worker Adjustment and Retraining Notification Act requires entities with 100 or more employees to notify employees 60 days in advance of covered plant closings and mass layoffs, unless otherwise specified).

When evaluating whether employees are required to render service beyond the minimum retention period, we believe the retention period should be determined from the date the termination plan meets all of the criteria in ASC 420-10-25-4 and the plan has been communicated to employees (i.e., the communication date). Consider the following illustration:

#### **Illustration 4-6: Future service period exists beyond the legal notification period**

On 31 December 20X1, Company Z, pursuant to a formal plan of termination, notifies 200 employees of their involuntary termination effective 65 days hence. One-time termination benefits subject to ASC 420 will be paid upon termination, but no earlier. The local laws require a minimum notification period of 60 days. At 31 December 20X1 (the communication date), Company Z cannot record the liability (expense) for the one-time termination benefits because a future service period exists which extends beyond the legal notification period. Accordingly, Company Z would recognize the liability (expense) ratably over the 65 days between the communication date and the termination date. The minimum notification period must not exceed the legal notification period or if a legal notification period does not exist, 60 days.

#### **Excerpt from Accounting Standards Codification**

##### **Exit or Disposal Cost Obligations – Overall**

##### *Subsequent Measurement – Changes in Estimates*

##### **420-10-35-3**

If a plan of termination changes and employees that were expected to be terminated within the minimum retention period are retained to render service beyond that period, a liability previously recognized at the **communication date** shall be adjusted to the amount that would have been recognized if the provisions of paragraph 420-10-25-9 had been applied in all periods subsequent to the communication date.

If a plan of termination changes and employees who were expected to be terminated within the minimum retention period are retained to render service beyond that period, the measurement of the liability previously recognized at the communication date should be adjusted to reflect that change. That is, the liability should be

adjusted to the amount that would have been recognized if the liability were originally being recognized over the service period (i.e., ratably over the service period). The cumulative catch-up of such a change should be recognized as an adjustment to the liability in the period of change and reported in the same line item(s) in the income statement used when the liability was initially recognized. The catch-up approach adjusts the carrying amount of the liability to the present value of the estimated cash flows, discounted at the credit-adjusted, risk-free rate that was used to measure the liability initially. Consider the following illustration.

**Illustration 4-7: Change in future service period**

Company A originally intended to involuntarily terminate 100 employees 60 days from the communication date and pay total severance of \$1,000 at the date of termination. Assume 60 days is the minimum retention period. Due to a change in plans, 45 days after the communication date Company A decided to extend the termination date by an additional 40 days (i.e., a total of 100 days after the communication date) and, thus, beyond the minimum retention period. As a result of the extension, Company A must record the following cumulative catch-up adjustment to the liability. For simplicity purposes this example ignores the effect of discounting.

Reverse previously recorded severance liability	\$ 1,000
Record severance earned $45/100 \times 1,000$ (amended liability)	<u>450</u>
Cumulative catch-up adjustment (decrease to the liability)	<u>\$ 550</u>

The remaining \$550 should be accrued ratably over the remaining 55-day (100-45) future service period.

#### 4.4 Fair value considerations

As noted in section 3.2, *Initial measurement*, employee termination costs initially are measured at fair value, generally using a present value technique that incorporates valuation assumptions, including the credit-adjusted risk-free rate. The timing for recognizing a liability and the amount of liability recognized under ASC 420 are dependent on whether employees are required to render future service to receive the termination benefits. If employees are required to render service until they are terminated and that service period extends beyond a “minimum retention period,” the liability (expense) should be recognized ratably over the future service period, even if the benefit formula used to calculate the termination benefit is based on past service.

Because a liability for employee termination costs within the scope of ASC 420 must meet strict criteria to be recognized, little uncertainty generally exists with respect to the timing and amount of the future cash flows. Accordingly, the effect of certain valuation assumptions, such as a market risk premium, will likely be insignificant. This point is made by the FASB in ASC 420-10-55-6, which states that “[i]n this case, a risk premium is not considered in the present value measurement. Because the amounts of the cash flows will be fixed and certain as of the termination date, marketplace participants would not demand a risk premium.”

#### 4.5 Subsequent measurement

As described in section 3.3, *Subsequent measurement*, a change resulting from a revision to either the timing or the amount of estimated cash flows over the future service period should be measured using the credit-adjusted, risk-free rate that was used to measure the liability initially. The cumulative effect of the change should be recognized as an adjustment to the liability in the period of the change. Because this is not a fair value measurement, ASC 820 does not apply. Also, as described in section 3.3, *Subsequent measurement*, changes in the liability due to the passage of time are recognized as an increase in the carrying amount of the liability and as an expense (e.g., accretion expense).

Example 2 from ASC 420 is presented below to illustrate these concepts.

### **Excerpt from Accounting Standards Codification**

#### **Exit or Disposal Cost Obligations – Overall**

#### *Implementation Guidance and Illustrations*

#### ***Example 2: One-Time Employee Termination Benefits – Stay Bonus-Future Service Required***

##### **420-10-55-4**

This Example assumes that an entity has a one-time benefit arrangement established by a plan of termination that meets the criteria in paragraph 420-10-25-4 and has been communicated to employees.

##### **420-10-55-5**

An entity plans to shut down a manufacturing facility in 16 months and, at that time, terminate all of the remaining employees at the facility. To induce employees to stay until the facility is shut down, the entity establishes a one-time stay bonus arrangement. Each employee that stays and renders service for the full 16-month period will receive as a termination benefit a cash payment of \$10,000, which will be paid 6 months after the termination date. An employee that leaves voluntarily before the facility is shut down will not be entitled to receive any portion of the termination benefit. In accordance with paragraph 420-10-25-9, a liability for the termination benefits would be measured initially at the communication date and, in accordance with paragraph 420-10-30-6, based on the fair value of the liability as of the termination date and recognized ratably over the future service period. The fair value of the liability as of the termination date would be adjusted cumulatively for changes resulting from revisions to estimated cash flows over the future service period, measured using the credit-adjusted risk-free rate that was used to measure the liability initially (as illustrated in this Example).

##### **420-10-55-6**

The fair value of the liability as of the termination date is \$962,240, estimated at the communication date using an expected present value technique. The expected cash flows of \$1 million (to be paid 6 months after the termination date), which consider the likelihood that some employees will leave voluntarily before the facility is shut down, are discounted for 6 months at the credit-adjusted risk-free rate of 8 percent. In this case, a risk premium is not considered in the present value measurement. Because the amounts of the cash flows will be fixed and certain as of the termination date, marketplace participants would not demand a risk premium.

##### **420-10-55-7**

Therefore, a liability of \$60,140 would be recognized in each month during the future service period (16 months).

##### **420-10-55-8**

After eight months, more employees than originally estimated leave voluntarily. The entity adjusts the fair value of the liability as of the termination date to \$769,792 to reflect the revised expected cash flows of \$800,000 (to be paid 6 months after the termination date), discounted for 6 months at the credit-adjusted risk-free rate that was used to measure the liability initially (8 percent). Based on that revised estimate, a liability (expense) of \$48,112 would have been recognized in each month during the future service period. Thus, the liability recognized to date of \$481,120 ( $\$60,140 \times 8$ ) would be reduced to \$384,896 ( $\$48,112 \times 8$ ) to reflect the cumulative effect of that change (of \$96,224). A liability of \$48,112 would be recognized in each month during the remaining future service period (8 months). Accretion expense would be recognized after the termination date in accordance with the guidance beginning in paragraph 420-10-35-1 and in paragraph 420-10-45-5.

## 4.6

**Voluntary and involuntary termination benefits****Excerpt from Accounting Standards Codification****Exit or Disposal Cost Obligations – Overall***Recognition***420-10-25-10**

If a plan of termination that meets the criteria in paragraph 420-10-25-4 includes both involuntary termination benefits and termination benefits offered for a short period of time in exchange for employees' voluntary termination of service, a liability for the involuntary termination benefits shall be recognized in accordance with this Subtopic. A liability for the incremental voluntary termination benefits (the excess of the voluntary termination benefit amount over the involuntary termination benefit amount) shall be recognized in accordance with paragraphs 712-10-25-1 through 25-3. For an illustration of this situation, see Example 3 (paragraph 420-10-55-9).

Under ASC 712, special termination benefits are benefits offered for a short period of time in exchange for an employee's voluntary termination of service (e.g., declining economic conditions may force an employer to reduce its work force). A liability for a special termination benefit is recorded when the employee accepts the offer and the amount is reasonably estimable. A contractual termination benefit under ASC 712 is a benefit that, under the terms of a plan, becomes payable only if a specified event, such as a plant closing, occurs. The liability relating to a contractual termination benefit under ASC 712 is recorded when it becomes probable that the employees will be entitled to the contractual benefits and the amount of the contractual benefits can be reasonably estimated.

The following illustration from ASC 420-10-55-9 and 55-10 provides an example of a liability that will fall within the scope of both ASC 420 and ASC 712.

**Illustration 4-8: Voluntary and involuntary benefits**

Assume an entity initiates changes to streamline operations in a particular location and determines that, as a result, it no longer needs 100 of the employees that currently work in that location. The plan of termination provides for both voluntary and involuntary termination benefits (in the form of cash payments). Specifically, the entity offers each employee (up to 100 employees) that voluntarily terminates within 30 days a voluntary termination benefit of \$10,000 to be paid at the separation date. Each employee that is involuntarily terminated thereafter (to reach the target of 100) will receive an involuntary termination benefit of \$6,000 to be paid at the termination date. The entity expects all 100 employees to leave (voluntarily or involuntarily) within the minimum retention period. In accordance with ASC 420-10-25-6 through 25-8, a liability for the involuntary termination benefit (of \$6,000 per employee) would be recognized at the communication date and, in accordance with ASC 420-10-30-4 through 30-6, measured at its fair value. In this case, because of the short discount period, \$600,000 may not be materially different from the fair value of the liability at the communication date. As noted in ASC 420-10-25-10, a liability for the incremental voluntary termination benefit (of \$4,000 per employee) would be recognized in accordance with ASC 712-10-25-1 through 25-3 when employees accept the offer.

Illustration 4-9 provides another example of a one-time employee termination benefit where a portion of the benefit meets the criteria to be recognized as of the termination date in accordance with ASC 420 and a portion of the termination benefit will be recognized at a later date in accordance with ASC 712.

**Illustration 4-9: Voluntary and involuntary benefits**

An entity has an approved written termination plan to exit part of its US operations. Under the plan, the company will close four manufacturing facilities, which will result in 1,000 employees being terminated. On 15 December 20X1, the company communicated a special one-time benefit arrangement in sufficient detail to enable employees, if terminated, to determine the type and amount of benefits they would receive (i.e., the communication date). All employees will be terminated within the minimum retention period (60 days in this example).

The benefits to be paid depend on whether the termination is voluntary or involuntary. All employees who voluntarily resign will receive \$10,000 and all employees who are involuntarily terminated will receive \$5,000. The company initially anticipated that 500 employees would leave voluntarily. In December, 100 employees voluntarily accepted the offer and signed a termination agreement.

On 15 December 20X1, the company recorded an accrual of \$5,000,000 related to the 1,000 employees that are to be involuntarily terminated because ASC 420 requires a liability (expense) to be recognized for termination benefits that are not part of an ongoing employee benefit plan when the following conditions are met:

- ▶ management approved the termination plan and established the benefits that the current employees will receive
- ▶ the benefit arrangement is communicated in sufficient detail to enable employees to determine their benefit
- ▶ the plan specifically identifies the number, job classification, and location of the employees to be terminated
- ▶ the employees are not required to render future service to receive the benefits
- ▶ 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

In addition, the company recorded an accrual of \$500,000 for the 100 employees who elected to resign. The expense represents the incremental amount that would be recognized as a special termination benefit in accordance with ASC 712, which requires a liability to be recognized when the employee accepts the offer and the amount can be reasonably estimated.

If additional employees volunteer to terminate after the balance sheet date, for example, on 18 January 20X2, an additional accrual for those employees would be recorded at that time pursuant to ASC 712.

## 4.7 Interaction with other accounting pronouncements

Numerous accounting pronouncements address the accounting and reporting for employee termination benefits. The following is a brief overview of those pronouncements.

### 4.7.1 ASC 715

ASC 715 prescribes the accounting by employers that offer postretirement benefits to their employees, including termination benefits provided under an ongoing benefit arrangement that are enhancements to an existing defined benefit pension (ASC 715-30) or other postretirement benefit plan (ASC 715-60). Generally, ASC 715 requires the recognition of the cost of providing such benefits over the employees' service period. Refer to section 9 of our FRD, *Postretirement benefits*, for more guidance on the application of ASC 715.

Two types of termination benefits are addressed in ASC 715:

- ▶ Special termination benefits are those offered by the employer to some or all of its employees for a short period of time for a special purpose (e.g., declining industry conditions may force an employer to reduce the size of its work force). A liability and expense are generally recorded for a special termination benefit under ASC 715 when (1) the employee accepts the offer and (2) the amount is reasonably estimable.
- ▶ Contractual termination benefits provide contractual benefits under the terms of a plan that becomes payable only if a specified event occurs, such as a plant closing. A liability and expense are recorded for such benefits under ASC 715 when (1) it is probable that the employees will be entitled to the benefits and (2) the amount is reasonably estimable.

### 4.7.2 **ASC 712**

ASC 712 addresses the accounting for postemployment benefits promised to employees (e.g., lump sum payments, future payments or both), unless the employer-provided benefit is specifically addressed by other accounting standards.

For additional discussion of accounting for termination benefits pursuant to ASC 712, refer to section 4.2, *One-time vs. ongoing benefit arrangements*.

### 4.7.3 **ASC 710**

ASC 710 applies to deferred compensation contracts with individual employees if those contracts, taken together, are not equivalent to a postretirement benefit plan covered under ASC 715. The estimated amount of future payments to be made under such contracts should be accrued over the period of active employment from the time the contract is entered into. Involuntary termination benefits that are included in these contracts should be accrued once it becomes probable the employee will be terminated.

# 5 Contract termination costs

## Excerpt from Accounting Standards Codification

### Exit or Disposal Cost Obligations – Overall

#### *Recognition*

#### *420-10-25-11*

For purposes of this Subtopic, costs to terminate a contract (excluding leases within the scope of Topic 842) are either of the following:

- a. Costs to terminate the contract before the end of its term
- b. Costs that will continue to be incurred under the contract for its remaining term without economic benefit to the entity.

ASC 420 addresses termination costs for contracts (excluding leases within the scope of ASC 842) in connection with an exit or disposal activity. The accounting for the termination of a lease is addressed by ASC 842, discussed in our FRD, *Lease accounting: Accounting Standards Codification 842, Leases*. The scope of ASC 420 is broad and applicable to costs to terminate any contract (excluding leases within the scope of ASC 842) before the end of its term, such as a penalty to cancel a service contract.

## 5.1 Costs to terminate a contract

## Excerpt from Accounting Standards Codification

### Exit or Disposal Cost Obligations – Overall

#### *Recognition*

#### *420-10-25-12*

A liability for costs to terminate a contract before the end of its term shall be recognized when the entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty).

#### *Initial Measurement*

#### *420-10-30-7*

A liability for costs to terminate a contract before the end of its term shall be measured at its fair value when the entity terminates the contract in accordance with the contract terms (for example, when the entity gives written notice to the counterparty within the notification period specified by the contract or has otherwise negotiated a termination with the counterparty).

In discussing this provision, the Board concluded that having exercised its option to terminate a contract by communicating that decision to the counterparty, an entity has a legal obligation under the contract to pay the penalty or other costs specified by the contract. Consider the following illustration.

**Illustration 5-1: Contract termination obligation**

ABC company entered into a renewable energy contract with XYZ Company for a 20-year term. The arrangement is not a lease within the scope of ASC 842. Nine years into the arrangement, ABC company determines that it no longer needs the renewable energy it receives under the contract. As a result, ABC company negotiates with XYZ Company and commits to a buyout effective at the end of year 10. The terms of the buyout are legally binding on both ABC company and XYZ Company. As a result, ABC company must accrue the termination payment (buyout) at the time a contractual commitment has been made.

**5.1.1 Fair value considerations**

In most situations, there will not be a significant amount of time between exercising a contract termination and the payment of the termination fee. As a result, the effects of a fair value measurement on most contract termination costs generally will not be significant. When the payment of a contractual termination fee follows shortly after notifying the counterparty, or concluding negotiations with the counterparty, the effect of a credit-adjusted risk-free rate often will not be significant. Further, both the amount and timing of the payment in such a case is generally certain, so a market risk premium should not have a significant effect. A market risk premium is designed to compensate for uncertainty as to the amount and timing of cash flows. The fair value of the liability should consider an adjustment for non-performance risk and a profit margin demanded by a third party, if significant.

**5.2 Costs that will continue to be incurred under a contract****Excerpt from Accounting Standards Codification****Exit or Disposal Cost Obligations – Overall***Recognition***420-10-25-13**

A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be recognized at the **cease-use date**.

*Initial Measurement***420-10-30-9**

A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity shall be measured at its fair value at the cease-use date.

**5.2.1 Cease-use date**

A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity should be recognized and measured at its fair value when the entity ceases using the right conveyed by the contract (e.g., the right to receive goods or services). The FASB refers to this approach as a “cease-use date approach.”

**5.2.2 Impairment of an unrecognized asset**

ASC 420 does not address the impairment of an unrecognized asset (e.g., contractual right to receive a good or service) while it is being used. The EITF discussed the accounting by the purchaser and seller for losses on firmly committed executory contracts in EITF 99-14 and EITF 00-26, respectively. However, the Task Force did not reach a consensus on either issue. ASC 420 also does not address the impairment of a recognized asset, including an intangible asset. Instead, the impairment of a recognized asset is addressed in ASC 360 and ASC 350 for property, plant and equipment and goodwill and indefinite-lived intangible assets, respectively.



### 5.2.3 Initial measurement

A liability for costs that will continue to be incurred under a contract for its remaining term without economic benefit to the entity should be measured at its fair value at the cease-use date.

### 5.2.4 Fair value considerations

The fair value of a liability for a contract termination under a cease-use date approach is the present value of the contractual obligation adjusted for valuation assumptions (e.g., market risk premium and/or profit margin) that reflect the amount a market participant would require to assume the obligation at the measurement date. Refer to section 3.2.1, *Fair value*, for further details.

### 5.2.5 Subsequent measurement

For the subsequent measurement of contract termination costs, the same rules apply as for other costs associated with an exit or disposal activity. That is, changes to the liability as a result of the timing and amount of estimated cash flows should be measured using the credit-adjusted, risk-free rate that was used to measure the liability initially with a resulting adjustment to be recorded in the period of change. As noted in section 3.3, *Subsequent measurement*, the subsequent measurement of a cost associated with an exit or disposal activity is not a fair value measurement.

# 6 Other associated costs

## Excerpt from Accounting Standards Codification

### Exit or Disposal Cost Obligations – Overall

#### *Recognition*

##### **420-10-25-14**

Other costs associated with an exit or disposal activity include, but are not limited to, costs to consolidate or close facilities and relocate employees.

##### **420-10-25-15**

The liability shall not be recognized before it is incurred, even if the costs are incremental to other operating costs and will be incurred as a direct result of a plan. A liability for other costs associated with an exit or disposal activity shall be recognized in the period in which the liability is incurred (generally, when goods or services associated with the activity are received).

#### *Initial Measurement*

##### **420-10-30-10**

A liability for other costs associated with an exit or disposal activity shall be measured at its fair value in the period in which the liability is incurred (generally, when goods or services associated with the activity are received).

Other costs associated with an exit or disposal activity may include, for example, moving costs, security costs for a closed facility and employee relocation costs. Possible goods or services received in connection with such other costs could include, for example, consulting services, relocation services or new computer software.

ASC 420 specifies that a liability should not be recognized before it is incurred even if the costs are incremental to other operating costs and will be incurred as a direct result of that plan. Consider the following illustration.

### **Illustration 6-1: Other associated costs**

Company X will consolidate two of its facilities pursuant to an entity-wide restructuring plan. The plan was approved on 1 December 20X0. As a result, Company X hired an outside company to coordinate the consolidation of the facilities (hiring of moving companies and getting the vacated facility ready to sell). These costs have been specifically identified in the plan of termination and are estimable based on information received from the outside company. The outside company is to commence its services 1 February 20X1. At 31 December 20X0, Company X cannot record this liability (expense) pursuant to ASC 420 because the costs have not yet been incurred. Company X should record the liability (expense) when the services are received.

Future operating losses that an entity expects to incur in connection with an exit or disposal activity are not directly addressed in ASC 420. However, the FASB clarified in paragraph B52 of the Basis for Conclusions of Statement No. 146 that future operating losses do not meet the definition of a liability and should be recognized as incurred. Additionally, costs for maintaining idle property cannot be recognized at the commitment date under ASC 420, even if they are of no continuing benefit to the entity. Instead, they would be recognized as incurred. Refer to section 5, *Contract termination costs*, for discussion of costs incurred under a contract that has no continuing economic benefit to the entity.

# 7 Presentation and disclosure

## 7.1 Presentation

### Excerpt from Accounting Standards Codification

#### Exit or Disposal Cost Obligations – Overall

##### *Derecognition*

##### **420-10-40-1**

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

##### *Other Presentation Matters*

##### *Changes in Estimates*

##### **420-10-45-1**

The cumulative effect of a change resulting from a revision to either the timing or the amount of estimated cash flows shall be reported in the same line item(s) in the income statement (statement of activities) used when the related costs were recognized initially in the period of change.

##### *Exit or Disposal Activity Involving a Discontinued Operation*

##### **420-10-45-2**

Costs associated with an exit or disposal activity involving a discontinued operation shall be included within the results of discontinued operations in accordance with Section 205-20-45.

##### *Income from Continuing Operations*

##### **420-10-45-3**

Costs associated with an exit or disposal activity that does not involve a discontinued operation shall be included in income from continuing operations before income taxes in the income statement of a business entity and in income from continuing operations in the statement of activities of a not-for-profit entity (NFP). Separate presentation of exit and disposal costs in the income statement is not prohibited. If a subtotal such as income from operations is presented, it shall include the amounts of those costs.

##### **420-10-45-4**

[Paragraph not used]

##### **420-10-45-5**

Accretion expense shall not be considered interest cost for purposes of classification in the income statement (statement of activities).

##### **420-10-45-6**

See paragraph 420-10-40-1 for the income statement presentation when the liability is reversed.

If an exit or disposal activity does not involve a discontinued operation, costs associated with that activity should be included in income from continuing operations before income taxes in the income statement of a business entity and in income from continuing operations in the statement of activities of a not-for-profit entity (NFP). If the exit or disposal activity involves a discontinued operation, costs associated with that activity should be included in the results of discontinued operations in accordance with ASC 205-20.

Revisions to liabilities for costs related to an exit or disposal activity should be recorded through the same line item(s) in the income statement used when the costs were initially recognized. If an event or circumstance occurs that discharges or removes an entity's responsibility to settle a liability for a cost associated with an exit or disposal activity recognized in a prior period, the liability should be reversed. The related costs also should be reversed through the same line item(s) in the income statement in which the costs initially were recognized. In some instances, this may involve reconstituting an income statement line item years after the original charge was presented.

SAB Topic 5.P.3 provides additional guidance regarding the income statement presentation of restructuring charges.

### Excerpt from SAB Topic 5.P.3

#### Exit or Disposal Cost Obligations – Overall

##### *SEC Materials*

##### *420-10-S99-1*

The following is the text of SAB Topic 5.P.3, Income Statement Presentation of Restructuring Charges.

**EY's note:** This SAB Topic has not been updated to reflect the content of ASU 2015-01 on eliminating extraordinary items.

**Facts:** Restructuring charges often do not relate to a separate component of the entity, and, as such, they would not qualify for presentation as losses on the disposal of a discontinued operation. Additionally, since the charges are not both unusual and infrequent FN15 they are not presented in the income statement as extraordinary items.

FN15 See FASB ASC paragraph 225-20-45-2.

**Question 1:** May such restructuring charges be presented in the income statement as a separate caption after income from continuing operations before income taxes (i.e., preceding income taxes and/or discontinued operations)?

**Interpretive Response:** No. FASB ASC paragraph 220-20-45-1 (Income Statement–Reporting Comprehensive Income Topic) states that items that do not meet the criteria for classification as an extraordinary item should be reported as a component of income from continuing operations. FN16 Neither FASB ASC Subtopic 225-20, Income Statement–Extraordinary and Unusual Items, nor Rule 5-03 of Regulation S-X contemplate a category in between continuing and discontinued operations. Accordingly, the staff believes that restructuring charges should be presented as a component of income from continuing operations, separately disclosed if material. Furthermore, the staff believes that a separately presented restructuring charge should not be preceded by a sub-total representing "income from continuing operations before restructuring charge" (whether or not it is so captioned). Such a presentation would be inconsistent with the intent of FASB ASC Subtopic 225-20.

FN16 FASB ASC paragraph 220-20-45-1 further provides that such items should not be reported on the income statement net of income taxes or in any manner that implies that they are similar to extraordinary items.

Question 2: Some registrants utilize a classified or "two-step" income statement format (i.e., one which presents operating revenues, expenses and income followed by other income and expense items). May a charge which relates to assets or activities for which the associated revenues and expenses have historically been included in operating income be presented as an item of "other expense" in such an income statement?

Interpretive Response: No. The staff believes that the proper classification of a restructuring charge depends on the nature of the charge and the assets and operations to which it relates. Therefore, charges which relate to activities for which the revenues and expenses have historically been included in operating income should generally be classified as an operating expense, separately disclosed if material. Furthermore, when a restructuring charge is classified as an operating expense, the staff believes that it is generally inappropriate to present a preceding subtotal captioned or representing operating income before restructuring charges. Such an amount does not represent a measurement of operating results under GAAP.

Conversely, charges relating to activities previously included under "other income and expenses" should be similarly classified, also separately disclosed if material.

The SEC staff has also commented on the income statement classification of inventory markdowns and other costs associated with restructuring activities, as follows.

### **Excerpt from Accounting Standards Codification**

#### **Exit or Disposal Cost Obligations – Overall**

##### ***SEC Materials***

##### ***420-10-S99-3***

The following is the text of SEC Observer Comment: Classification of Inventory Markdowns and Other Costs Associated with Restructuring.

Subtopic 420-10 states that costs associated with exit or disposal activities that do not involve a discontinued operation should be included in income from continuing operations before taxes. If a subtotal such as "income from operations" is presented, that Subtopic indicates that subtotal should include the amounts of exit or disposal costs. However, the guidance does not address where within income from continuing operations or income from operations inventory markdowns associated with an exit or restructuring activity. The SEC staff recognizes that there may be circumstances in which it can be asserted that inventory markdowns are costs directly attributable to a decision to exit or restructure an activity. However, the staff believes that it is difficult to distinguish inventory markdowns attributable to a decision to exit or restructure an activity from inventory markdowns attributable to external market factors that are independent of a decision to exit or restructure an activity. Further, the staff believes that decisions about the timing, method, and pricing of dispositions of inventory generally are considered to be normal, recurring activities integral to the management of the ongoing business. Accordingly, the SEC staff believes that inventory markdowns should be classified in the income statement as a component of cost of goods sold.

## 7.2

## Disclosure

**Excerpt from Accounting Standards Codification****Exit or Disposal Cost Obligations – Overall***Disclosure***420-10-50-1**

All of the following information shall be disclosed in notes to financial statements that include the period in which an exit or disposal activity is initiated and any subsequent period until the activity is completed:

- a. A description of the exit or disposal activity, including the facts and circumstances leading to the expected activity and the expected completion date
- b. For each major type of cost associated with the activity (for example, **one-time employee termination benefits**, contract termination costs, and other associated costs), both of the following shall be disclosed:
  1. The total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date
  2. A reconciliation of the beginning and ending liability balances showing separately the changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and any adjustments to the liability with an explanation of the reason(s) why.
- c. The line item(s) in the income statement or the statement of activities in which the costs in (b) are aggregated
- d. For each reportable segment, as defined in Subtopic 280-10, 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) why
- e. If a liability for a cost associated with the activity is not recognized because fair value cannot be reasonably estimated, that fact and the reasons why.

Entities that are within the scope of ASC 280 also must disclose the amount of costs related to exit or disposal activities incurred in the period and cumulative-to-date costs by reportable segment. It is important to note that the disclosures above are required to be presented starting in the period in which an exit or disposal activity is initiated and in any subsequent period until the plan is completed, regardless of whether a liability for those costs is recognized at that date or not.

SAB Topic 5.P.4 requires that companies disclose information regarding exit and disposal activities in management's discussion and analysis (MD&A).

## Excerpt from SAB Topic 5.P.4

### Exit or Disposal Cost Obligations – Overall

#### SEC Materials

#### 420-10-S99-2

The following is the text of SAB Topic 5.P.4, Disclosures.

Beginning with the period in which the exit plan is initiated, FASB ASC Topic 420, Exit or Disposal Cost Obligations, requires disclosure, in all periods, including interim periods, until the exit plan is completed, of the following:

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

Question: What specific disclosures about restructuring charges has the staff requested to fulfill the disclosure requirements of FASB ASC Topic 420 and MD&A?

Interpretive Response: The staff often has requested greater disaggregation and more precise labeling when exit and involuntary termination costs are grouped in a note or income statement line item with items unrelated to the exit plan. For the reader's understanding, the staff has requested that discretionary, or decision-dependent, costs of a period, such as exit costs, be disclosed and explained in MD&A separately. Also to improve transparency, the staff has requested disclosure of the nature and amounts of additional types of exit costs and other types of restructuring charges FN17 that appear quantitatively or qualitatively material, and requested that losses relating to asset impairments be identified separately from charges based on estimates of future cash expenditures.

FN17 Examples of common components of exit costs and other types of restructuring charges which should be considered for separate disclosure include, but are not limited to, involuntary employee terminations and related costs, changes in valuation of current assets such as inventory writedowns, long term asset disposals, adjustments for warranties and product returns, leasehold termination payments, and other facility exit costs, among others.

The staff frequently reminds registrants that in periods subsequent to the initiation date that material changes and activity in the liability balances of each significant type of exit cost and involuntary employee termination benefits FN18 (either as a result of expenditures or changes in/reversals of estimates or the fair value of the liability) should be disclosed in the footnotes to the interim and

annual financial statements and discussed in MD&A. In the event a company recognized liabilities for exit costs and involuntary employee termination benefits relating to multiple exit plans, the staff believes presentation of separate information for each individual exit plan that has a material effect on the balance sheet, results of operations or cash flows generally is appropriate.

FN18 The staff would expect similar disclosures for employee termination benefits whether those costs have been recognized pursuant to FASB ASC Topic 420, FASB ASC Topic 712, Compensation – Nonretirement Postemployment Benefits, or FASB ASC Topic 715, Compensation – Retirement Benefits.

For material exit or involuntary employee termination costs related to an acquired business, the staff has requested disclosure in either MD&A or the financial statements of:

1. When the registrant began formulating exit plans for which accrual may be necessary,
2. The types and amounts of liabilities recognized for exit costs and involuntary employee termination benefits and included in the acquisition cost allocation, and.
3. Any unresolved contingencies or purchase price allocation issues and the types of additional liabilities that may result in an adjustment of the acquisition cost allocation.

The staff has noted that 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, the staff believes that 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. Whether or not currently recognizable in the financial statements, material exit or involuntary termination costs that affect a known trend, demand, commitment, event, or uncertainty to management, should be disclosed in MD&A. The staff believes that MD&A should include discussion of the events and decisions which gave rise to the exit costs and exit plan, and the likely effects of management's plans on financial position, future operating results and liquidity unless it is determined that a material effect is not reasonably likely to occur. Registrants should identify the periods in which material cash outlays are anticipated and the expected source of their funding. Registrants should also discuss material revisions to exit plans, exit costs, or the timing of the plan's execution, including the nature and reasons for the revisions.

The staff believes that the expected effects on future earnings and cash flows resulting from the exit plan (for example, reduced depreciation, reduced employee expense, etc.) should be quantified and disclosed, along with the initial period in which those effects are expected to be realized. This includes whether the cost savings are expected to be offset by anticipated increases in other expenses or reduced revenues. This discussion should clearly identify the income statement line items to be impacted (for example, cost of sales; marketing; selling, general and administrative expenses; etc.). In later periods if actual savings anticipated by the exit plan are not achieved as expected or are achieved in periods other than as expected, MD&A should discuss that outcome, its reasons, and its likely effects on future operating results and liquidity.

The staff often finds that, because of the discretionary nature of exit plans and the components thereof, presenting and analyzing material exit and involuntary termination charges in tabular form, with the related liability balances and activity (e.g., beginning balance, new charges, cash payments, other adjustments with explanations, and ending balances) from balance sheet date to balance sheet date, is necessary to explain fully the components and effects of significant restructuring charges. The staff believes that such a tabular analysis aids a financial statement user's ability to disaggregate the restructuring charge by income statement line item in which the costs would have otherwise been recognized, absent the restructuring plan, (for example, cost of sales; selling, general, and administrative; etc.).



# A

## Abbreviations used in this publication

<b>Abbreviation</b>	<b>FASB Accounting Standards Codification</b>
ASC 205-20	FASB ASC Subtopic 205-20, <i>Presentation of Financial Statements – Discontinued Operations</i>
ASC 220-20	FASB ASC Subtopic 220-20, <i>Income Statement – Reporting Comprehensive Income, Unusual or Infrequently Occurring Items</i>
ASC 225-20	FASB ASC Subtopic 225-20, <i>Income Statement, Unusual or Infrequently Occurring Items</i>
ASC 280	FASB ASC Topic 280, <i>Segment Reporting</i>
ASC 350	FASB ASC Topic 350, <i>Intangibles – Goodwill and Other</i>
ASC 360-10	FASB ASC Subtopic 360-10, <i>Property, Plant, and Equipment – Overall</i>
ASC 410-20	FASB ASC Subtopic 410-20, <i>Asset Retirement and Environmental Obligations – Asset Retirement Obligations</i>
ASC 420	FASB ASC Topic 420, <i>Exit or Disposal Cost Obligations</i>
ASC 450-20	FASB ASC Subtopic 450-20, <i>Contingencies – Loss Contingencies</i>
ASC 480	FASB ASC Topic 480, <i>Distinguishing Liabilities from Equity</i>
ASC 710	FASB ASC Topic 710, <i>Compensation – General</i>
ASC 712	FASB ASC Topic 712, <i>Compensation – Nonretirement Postemployment Benefits</i>
ASC 715	FASB ASC Topic 715, <i>Compensation – Retirement Benefits</i>
ASC 715-30	FASB ASC Subtopic 715-30, <i>Compensation – Retirement Benefits, Defined Benefit Plans – Pension</i>
ASC 715-60	FASB ASC Subtopic 715-60, <i>Compensation – Retirement Benefits, Defined Benefit Plans – Other Postretirement</i>
ASC 718	FASB ASC Topic 718, <i>Compensation – Stock Compensation</i>
ASC 805	FASB ASC Topic 805, <i>Business Combinations</i>
ASC 820	FASB ASC Topic 820, <i>Fair Value Measurement</i>
ASC 835-20	FASB ASC Subtopic 835-20, <i>Interest – Capitalization of Interest</i>
ASC 842	FASB ASC Topic 842, <i>Leases</i>
ASU 2015-01	FASB ASU 2015-01, <i>Income Statement – Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items</i>
ASU 2016-02	FASB ASU 2016-02, <i>Leases (Topic 842)</i>
<b>Abbreviation</b>	<b>Other Authoritative Standards</b>
IAS 37	International Accounting Standards 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i>
SAB Topic 5.P.3	SEC Staff Accounting Bulletin Topic 5.P.3, <i>Miscellaneous Accounting, Restructuring Charges, Income Statement Presentation of Restructuring Charges</i>
SAB Topic 5.P.4	SEC Staff Accounting Bulletin Topic 5.P.4, <i>Miscellaneous Accounting, Restructuring Charges, Disclosures</i>

<b>Abbreviation</b>	<b>Non-Authoritative Standards</b>
CON 6	FASB Concepts Statement No. 6, <i>Elements of Financial Statements</i>
CON 8	FASB Concepts Statement No. 8, <i>Elements of Financial Statements</i>
EITF 99-14	EITF Issue 99-14, <i>Recognition by a Purchaser of Losses on Firmly Committed Executory Contracts</i>
EITF 00-26	EITF Issue 00-26, <i>Recognition by a Seller of Losses on Firmly Committed Executory Contracts</i>
Statement 146	FASB Statement No. 146, <i>Accounting for Costs Associated with Exit or Disposal Activities</i>

# B Glossary

## Excerpt from Accounting Standards Codification

### Master Glossary

#### **Acquiree**

The business or businesses that the acquirer obtains control of in a business combination. This term also includes a nonprofit activity or business that a not-for-profit acquirer obtains control of in an acquisition by a not-for-profit entity.

#### **Acquirer**

The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

#### **Acquisition by a Not-for-Profit Entity**

A transaction or other event in which a not-for-profit acquirer obtains control of one or more nonprofit activities or businesses and initially recognizes their assets and liabilities in the acquirer's financial statements. When applicable guidance in Topic 805 is applied by a not-for-profit entity, the term business combination has the same meaning as this term has for a for-profit entity. Likewise, a reference to business combinations in guidance that links to Topic 805 has the same meaning as a reference to acquisitions by not-for-profit entities.

#### **Business**

Paragraphs 805-10-55-3A through 55-6 and 805-10-55-8 through 55-9 define what is considered a business.

#### **Business Combination**

A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. See also Acquisition by a Not-for-Profit Entity.

#### **Cease-Use Date**

The date the entity ceases using the right conveyed by the contract, for example, the right to use a leased property or to receive future goods or services.

**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

The date the entity ceases using the right conveyed by the contract, for example, to receive future goods or services.

#### **Communication Date**

The date the plan of termination for one-time employee termination benefits meets all of the criteria in paragraph 420-10-25-4 and has been communicated to employees.

#### **Contract**

An agreement between two or more parties that creates enforceable rights and obligations.

**Lease**

An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time.

**Note:** The following definition is Pending Content; see Transition Guidance in 842-10-65-1.

A contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.

**Legal Entity**

Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

**Legal Notification Period**

The notification period that an entity is required to provide to employees in advance of a specified termination event as a result of an existing law, statute, or contract.

**Not-for-Profit Entity**

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- a. All investor-owned entities
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

**One-Time Employee Termination Benefits**

Benefits provided to current employees that are involuntarily terminated under the terms of a one-time benefit arrangement.

**Restructuring**

A program that is planned and controlled by management, and materially changes either the scope of a business undertaken by an entity, or the manner in which that business is conducted, as defined by the International Accounting Standard No. 37 in 2002.

**Variable Interest Entity**

A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

# C

## Index of ASC references in this publication

ASC paragraph	Section	
410-20-55-15	3.2.1.4	Credit-adjusted risk-free rate
420-10-05-1	2	Scope
420-10-05-2	2	Scope
420-10-05-3	2	Scope
420-10-05-4	2	Scope
420-10-10-1	2	Scope
420-10-15-2	2	Scope
420-10-15-3	2	Scope
420-10-15-4	2	Scope
420-10-15-5	2	Scope
420-10-15-6	2	Scope
420-10-15-7	2	Scope
420-10-15-8	2	Scope
420-10-20	Appendix B	Glossary
420-10-25-1	3.1	Recognition
420-10-25-2	1	Overview
420-10-25-2	3.1	Recognition
420-10-25-3	3.1	Recognition
420-10-25-4	4	One-time termination benefits
420-10-25-4	4.3.1	Future service not required
420-10-25-5	4	One-time termination benefits
420-10-25-6	4	One-time termination benefits
420-10-25-6	4.6	Voluntary and involuntary termination benefits
420-10-25-7	4	One-time termination benefits
420-10-25-7	4.6	Voluntary and involuntary termination benefits
420-10-25-8	4	One-time termination benefits
420-10-25-8	4.6	Voluntary and involuntary termination benefits
420-10-25-9	4	One-time termination benefits
420-10-25-10	4.6	Voluntary and involuntary termination benefits
420-10-25-11	5	Contract termination costs
420-10-25-12	5.1	Costs to terminate a contract
420-10-25-13	5.2	Costs that will continue to be incurred under a contract
420-10-25-14	6	Other associated costs
420-10-25-15	6	Other associated costs
420-10-30-1	3.2.1	Fair value

ASC paragraph	Section	
420-10-30-2	3.2.1	Fair value
420-10-30-2	3.2.1.2	Effect of ASC 820 on ASC 420
420-10-30-3	3.2.1	Fair value
420-10-30-4	4.3	Timing of recognition and measurement of one-time benefit arrangements
420-10-30-4	4.6	Voluntary and involuntary termination benefits
420-10-30-5	4.3	Timing of recognition and measurement of one-time benefit arrangements
420-10-30-5	4.6	Voluntary and involuntary termination benefits
420-10-30-6	4.3	Timing of recognition and measurement of one-time benefit arrangements
420-10-30-6	4.6	Voluntary and involuntary termination benefits
420-10-30-7	5.1	Costs to terminate a contract
420-10-30-9	5.2	Costs that will continue to be incurred under a contract
420-10-30-10	6	Other associated costs
420-10-35-1	3.3	Subsequent measurement
420-10-35-2	3.3	Subsequent measurement
420-10-35-3	4.3.3	Minimum retention period exception
420-10-35-4	3.3	Subsequent measurement
420-10-40-1	7.1	Presentation
420-10-45-1	7.1	Presentation
420-10-45-2	7.1	Presentation
420-10-45-3	7.1	Presentation
420-10-45-4	7.1	Presentation
420-10-45-5	7.1	Presentation
420-10-45-6	7.1	Presentation
420-10-50-1	7.2	Disclosure
420-10-55-1	4.2	One-time vs. ongoing benefit arrangements
420-10-55-1	4.2.1	Other factors to consider when determining whether an ongoing benefit arrangement exists
420-10-55-2	4.3.1	Future service not required
420-10-55-3	4.3.1	Future service not required
420-10-55-4	4.5	Subsequent measurement
420-10-55-5	4.5	Subsequent measurement
420-10-55-6	4.4	Fair value considerations
420-10-55-6	4.5	Subsequent measurement
420-10-55-7	4.5	Subsequent measurement
420-10-55-8	4.5	Subsequent measurement
420-10-55-9	4.6	Voluntary and involuntary termination benefits
420-10-55-10	4.6	Voluntary and involuntary termination benefits
420-10-55-16	4.2	One-time vs. ongoing benefit arrangements
420-10-55-17	4.2	One-time vs. ongoing benefit arrangements
420-10-55-18	4.2	One-time vs. ongoing benefit arrangements

<b>ASC paragraph</b>	<b>Section</b>	
420-10-55-19	4.2	One-time vs. ongoing benefit arrangements
420-10-S99-1	7.1	Presentation
420-10-S99-2	7.2	Disclosure
420-10-S99-3	7.1	Presentation
712-10-25-1	4.6	Voluntary and involuntary termination benefits
712-10-25-2	4.6	Voluntary and involuntary termination benefits
712-10-25-3	4.6	Voluntary and involuntary termination benefits
820-10-35-24	3.2.1.1	Overview of ASC 820
820-10-35-25	3.2.1.1	Overview of ASC 820
820-10-35-26	3.2.1.1	Overview of ASC 820
820-10-35-27	3.2.1.1	Overview of ASC 820
820-10-35-37	3.2.1.1	Overview of ASC 820
820-10-55-3F	3.2.1.1	Overview of ASC 820
820-10-35-54E	3.2.1.3	Market risk premium

# D Summary of important changes

The following highlights the topics for which substantive updates have been made in recent editions of this publication. Non-substantive or clarifying changes are not listed.

In the August 2023 update, references to ASC 840, *Leases*, have been removed throughout the document. In addition, Section 5A: Contract termination costs - before the adoption of ASC 842 has also been removed.

## **Section 1: Overview**

- ▶ Section 1 was updated for current standard setting activities. (April 2022)
- ▶ Section 1 was updated with a table depicting what is generally included vs. excluded from the scope of ASC 420. (April 2022)

## **Section 3: Recognition and measurement**

- ▶ Section 3.1 was updated for current standard setting activities. (April 2022)

## **Section 4: One-time termination benefits**

- ▶ Section 4.3.3 was updated to include interpretive guidance on determining the retention period (August 2023)



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