SFAS No. 146
New Rules for Accounting for Costs Associated with Exit or Disposal Activities
by Alan Reinstein

SFAS No. 146 requires companies to recognize costs associated with exit or disposal activities at the time they are incurred rather than at the date of a commitment to an exit or disposal plan. It affects lease termination costs, certain employee severance costs associated with a restructuring, discontinued operations, plant closings, or other exit or disposal activities.

SFAS No. 146—Accounting for Costs Associated with Exit or Disposal Activities—provides more consistent accounting for costs associated with exit or disposal activities at the time they are incurred rather than at the date of a commitment to an exit or disposal plan. These costs may include lease termination, certain employee severance associated with a restructuring, discontinued operations, plant closings, or other exit or disposal activity. Requiring better matching of revenues and expenses, its provisions should generate more relevant and credible financial statements.

Issued in June 2002, SFAS 146 supersedes the provisions of the FASB’s Emerging Issues Task Force (EITF) Issue No. 94-3, “Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring).” SFAS 146 concludes that since a commitment to a plan, by itself, does not create a present obligation from the entity to others, entities should change the timing of recognition of costs associated with exit or disposal activities. In many cases, they will recognize such costs as liabilities in periods following a commitment to a plan, rather than at the date of the commitment.

Employee severance costs. SFAS 146 changes how management accounts for “one-time termination benefits” for employees who have worked longer than 60 days (unless a contract or law mandates a longer notification period). Management should accrue such benefits over the periods that employees perform such services, rather than expense such costs when it first communicates the termination arrangement to its employees.

At the time the employees leave the firm (i.e., the termination date), many entities require terminated employees to render future services before they can receive termination benefits. In such cases, before the termination date management should estimate the timings and future costs and benefits of how such employee departures likely will occur. This affects gross termination benefits, adjusting cash flows for expected departures, and discounting the resulting cash flows over the service period. For example, assume that management offers $10,000 to any of its 100 employees working for the next year (to be received four months after the 12 months), but nothing to those leaving before then. Management
estimates the 16-month liability at $1 million and the fair value of the benefit at the termination date at $980,000. The estimate, made at the time of the offer, uses a present-value approach, discounted at a 6% credit-adjusted risk-free rate. The entity will recognize a $81,667 expense each month (i.e., $980,000/12 months) during the future service period. From the termination date through the four months to the payment date, the entity would accrue $5,000 of monthly expense on the difference between the $980,000 recorded liability and the ultimate $1 million payment.

How lessors and lessees recognize contract termination costs. SFAS 146 changes accounting requirements for 1) lessors who pay lessees bonuses for abrogating leases early, and 2) lessees who break their leases, leading to such termination costs as rent-breaking penalties. To improve the matching of revenues and associated costs, management should record a liability for the fair value of the termination costs on the date that it terminates a contract containing such penalty clauses, net of expected payments from sublessees over their expected collection periods.

Lessees may also reduce their liabilities for terminating the lease at the cease-use date for reasonably obtainable sublease rentals for the property. Lessees should recognize the fair value of the liability for the cancellation penalty when it gives notice.

Lessees terminating a contract before its stated end period should record a liability at the termination date for the fair value of such termination costs, including termination penalties, but not remaining lease rentals after the notification date and before the cease-use date. For example, assume that a lessee has six years remaining on a lease with a one-year notification period and a $10,000 cancellation penalty. The lessee gives notice to terminate the lease on December 31, 2003 and vacates the property on December 31, 2004. The lessee should recognize the $10,000 cancellation penalty on the 2003 notice date and recognize 2004 lease rentals as incurred.

Entities also should ascertain when to incur liabilities associated with lease termination costs. For example, the SEC staff ruled recently that an entity that has “essentially” vacated a building but had a few employees still working there has not ceased using the property for purposes of measuring such lease termination costs.

Disclosures Requirements

Management should present the impairment within the balance sheet section Income from Continuing Operations Before Income Taxes. Information about exit and disposal activities, related costs, and changes in such costs must be presented in the Notes section of financial statements as the period from the time an exit or disposal activity is begun to the date the activity is completed. The Notes should include:

- Description of impaired long-lived asset (group) and circumstances leading to the impairment.
- Amount of impairment loss and caption in the income statement that includes the loss, if not presented separately on the face of the statement.
- Method(s) to determine fair value.
- Segment in which the impaired long-lived asset (asset group) is reported, if applicable.

Entities also should disclose the following in the Notes to its interim/annual financial statements that include the period in which an exit or disposal activity is initiated and any subsequent period until the activity is completed:

- Description of the exit or disposal activity, including facts and circumstances leading to the expected activity and expected completion date.
- For each major type of cost associated with the activity (e.g., one-time termination benefits, contract termination costs, and other associated costs), total amount expected to be incurred in connection with the activity, the amount incurred in the period, and the cumulative amount incurred to date.
- Reconcile opening and ending liability balances showing separately changes during the period attributable to costs incurred and charged to expense, costs paid or otherwise settled, and adjustments to the liability, explaining the reason(s) for the adjustments.
- For each reportable segment, 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, and disclose reasons for those adjustments.

- If a liability for a cost associated with an exit or disposal activity is not recognized because the entity cannot reasonably estimate the fair value of the liability, management should disclose that fact and the reasons for the inability to estimate fair value.

Example of Disclosures of SFAS 146

Many entities have already considered the effects of the new provisions of SFAS 146. For example, Eastman Kodak’s 2002 Annual Report states that:

SFAS No. 146 addresses the financial accounting and reporting for costs associated with exit or disposal activities and supersedes the EITF Issue No. 94-3, “Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring).” SFAS No. 146 requires recognition of the liability for costs associated with an exit or disposal activity when the liability is incurred. Under EITF 94-3, a liability for an exit cost was recognized at the date of the Company’s commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS No. 146 will impact the timing of recognition and the initial measurement of the amount of liabilities the Company recognizes in connection with exit or disposal activities initiated after December 31, 2002, the effective date of SFAS No. 146.

Given Kodak’s recent announcement of major restructuring, including large employee layoffs, the effects of SFAS 146 will undoubtedly be significant.

Summary

The provisions of SFAS 146 should provide better-matched, more consistent, and fuller reporting for restructuring costs. Bankers should now grasp SFAS 146’s key provisions in order to work with their clients and their CPAs to help derive credible financial statements.

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