

Statement of Financial Accounting Standards No. 43

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Accounting for Compensated Absences

November 1980



Financial Accounting Standards Board
of the Financial Accounting Foundation
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FAS 43: Accounting for Compensated Absences

FAS 43 Summary

This Statement requires an employer to accrue a liability for employees' rights to receive compensation for future absences when certain conditions are met. For example, this Statement requires a liability to be accrued for vacation benefits that employees have earned but have not yet taken; however, it generally does not require a liability to be accrued for future sick pay benefits, holidays, and similar compensated absences until employees are actually absent.

INTRODUCTION AND BACKGROUND INFORMATION

1. The FASB has been asked to consider practices used by employers to account for employee absences, such as vacation, illness, and holidays, for which it is expected that employees will be paid (referred to in this Statement as *compensated absences*). The Board has been advised that the following alternative accounting practices exist with respect to compensated absences: (a) the cost is accrued over some period before payment or (b) the cost is recognized when paid. The Board has considered those alternative accounting practices and concluded that a liability for employees' rights to receive compensation for future absences should be accrued as specified by this Statement.
2. This Statement does not apply to severance or termination pay, postretirement benefits, deferred compensation, stock or stock options issued to employees, or other long-term fringe benefits, such as group insurance or long-term disability pay. This Statement does not address the allocation of costs of compensated absences to interim periods. Furthermore, because the appropriate structure for setting accounting standards for state and local governmental units is currently under discussion, the FASB is proposing no change with respect to the nature of its involvement with pronouncements in the governmental area until that matter is resolved. Consequently, the Board has deferred a decision regarding whether this Statement should apply to state and local governmental units.
3. The Addendum to APB Opinion No. 2, *Accounting for the "Investment Credit,"* states that "... differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process..." and discusses the

application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum govern the application of this Statement to those operations of an employer that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

4. An Exposure Draft of a proposed Statement, *Accounting for Compensated Absences*, was issued on December 17, 1979. The Board received 217 comment letters in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them are discussed in Appendix A, "Summary of Consideration of Comments on Exposure Draft."

5. The Board has concluded that it can reach an informed decision on the basis of existing data without a public hearing and that the effective date and transition specified in paragraphs 8 and 9 are advisable in the circumstances.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

6. An employer shall accrue a liability for employees' compensation for future absences if *all* of the following conditions are met:

- a. The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered,
- b. The obligation relates to rights that vest ¹ or accumulate,²
- c. Payment of the compensation is probable, and
- d. The amount can be reasonably estimated.

If an employer meets conditions (a), (b), and (c) and does not accrue a liability because condition (d) is not met, that fact shall be disclosed.

7. Notwithstanding the conditions specified in paragraph 6, an employer is not required to accrue a liability for nonvesting accumulating rights to receive sick pay benefits ³ (that is, compensation for an employee's absence due to illness) for the reasons stated in paragraph 15.

Effective Date and Transition

8. This Statement shall be effective for fiscal years beginning after December 15, 1980, with earlier application encouraged. Accounting changes adopted to conform to the provisions of this Statement shall be applied retroactively. In the year that this Statement is first applied, the financial statements shall disclose the nature of any restatement and its effect on income before extraordinary items, net income, and related per share amounts for each year restated.

9. If retroactive restatement of all years presented is not practicable, the financial statements presented shall be restated for as many consecutive years as practicable and the cumulative effect of applying the Statement

shall be included in determining net income of the earliest year restated (not necessarily the earliest year presented). If it is not practicable to restate any prior year, the cumulative effect shall be included in net income in the year in which the Statement is first applied. (See paragraph 20 of APB Opinion No. 20, *Accounting Changes*.) The effect on income before extraordinary items, net income, and related per share amounts of applying this Statement in a year in which the cumulative effect is included in determining that year's net income shall be disclosed for that year.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Messrs. Kirk and Sprouse dissented.

Messrs. Kirk and Sprouse dissent because they believe the condition relating to "rights that vest or accumulate" (paragraph 6(b)) introduces unnecessary and irrelevant considerations in determining whether a liability for compensated absences has been incurred that should be recognized.

For benefits that have vesting provisions, the employee need not be absent to be compensated; therefore, services already rendered (condition 6(a)) is necessarily the past transaction or event that is referred to in the definition of liabilities as creating the obligation. For benefits that do not have vesting provisions, whether the benefits accumulate or are bestowed by outright grant by the employer is irrelevant and tends to detract from the central issue. The crucial question is whether the employer's liability is the result of employees rendering service (past presences) or being absent (future absences). Messrs. Kirk and Sprouse distinguish among the types of plans covered by this Statement believing, for example, that compensation for absences contingent on a specific event outside the control of the employer and employee, such as illness or jury duty, is attributable to those events. Compensation for absences that is not contingent on such events, for example vacations, is attributable to rendering service. Specifically, they believe the employer has a recordable liability for vacation pay and a contingency, but not a recordable liability for sick pay. Until illness occurs the employer has no liability; the employer does not owe anything until the contingent event, an illness, occurs.

Messrs. Kirk and Sprouse also are concerned that identical situations may continue to be accounted for differently because, under paragraph 7, a liability for nonvesting sick pay is not required but rather is permitted.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: SUMMARY OF CONSIDERATION OF COMMENTS ON EXPOSURE DRAFT

10. Some respondents questioned the need for a project on accounting for compensated absences. They indicated that the informational benefits of requiring a liability for compensated absences to be accrued do not justify the costs of doing so. The accrual ordinarily would create a one-time significant adjustment with little financial statement effect among periods thereafter. The Accounting Standards Division of the AICPA asked the FASB to consider the alternative practices used by employers to account for compensated absences because of the potential for significant unrecorded or understated liabilities in certain cases. In view of the existence of significantly different alternative practices, the universality of the transactions, and the potential for understatement of liabilities, the Board concluded that a Statement on the subject should be issued (a) to affirm that generally accepted accounting principles require that compensated absences be accounted for on the accrual basis and (b) to clarify the accounting for those absences.

11. Some respondents requested guidance on how compensated absences should be accounted for in interim periods. Other respondents indicated that providing interim reporting guidance in this Statement would involve significant issues that are currently being addressed in the elements and recognition phases of the Board's conceptual framework project. Those respondents recommended that, in light of the Board's decision to defer further action on its interim reporting project until those conceptual issues are resolved, the Statement should specify that it does not change existing interim reporting practices and that the provisions of APB Opinion No. 28, *Interim Financial Reporting*, are still appropriate. The Board agreed; accordingly, this Statement is concerned with the accrual of a liability for compensated absences rather than with the allocation of the costs of such absences to interim periods.

12. Some respondents indicated that accrual of a liability for compensated absences should be limited to those absences for which the right to receive compensation is vested. The liability would then reflect only amounts that employees would be paid for their rights to compensated absences if their employment terminated. The Board believes that those respondents' comments generally reflect an approach that is more restrictive than called for by the Board's definition of a liability in paragraph 22 of the revised FASB Exposure Draft, *Elements of Financial Statements of Business Enterprises* (elements Exposure Draft), which states:

Liabilities are probable future sacrifices of economic benefits stemming from present legal, equitable, or constructive obligations of a particular enterprise to transfer assets or provide services to other entities in the future as a result of past transactions or events affecting the enterprise.

The Board believes that a liability for amounts to be paid as a result of employees' rights to compensated absences should be accrued, considering anticipated forfeitures, in the year in which earned. For example, if new employees receive vested rights to two-weeks' paid vacation at the beginning of their second year of employment with no pro rata payment in the event of termination during the first year, the two-weeks' vacation

would be considered to be earned by work performed in the first year and an accrual for vacation pay would be required for new employees during their first year of service, allowing for estimated forfeitures due to turnover. Furthermore, the proposed definition of a liability does not limit an employer's liability for compensated absences solely to rights to compensation for those absences that eventually vest. The definition also encompasses a constructive obligation for reasonably estimable compensation for past services that, based on the employer's past practices, probably will be paid and can be reasonably estimated. Individual facts and circumstances must be considered in determining when nonvesting rights to compensated absences are earned by services rendered.

13. The requirement to accrue a liability for nonvesting rights to compensated absences depends on whether the unused rights (a) expire at the end of the year in which earned or (b) accumulate and are carried forward to succeeding years, thereby increasing the benefits that would otherwise be available in those later years. If the rights expire, the Board believes that a liability for future absences should not be accrued at year-end because the benefits to be paid in subsequent years would not be attributable to employee services rendered in prior years. (Jury duty and military leave benefits generally do not accumulate if unused and, unless they accumulate, a liability for those benefits would not be accrued at year-end.) On the other hand, if unused rights do accumulate and increase the benefits otherwise available in subsequent years, the Board believes a liability should be accrued at year-end to the extent that it is probable that employees will be paid in subsequent years for the increased benefits attributable to the accumulated rights and the amount can be reasonably estimated.

14. Board members' views differ regarding whether employees' rights to receive compensation for unused sick days that accumulate for possible future use but do not vest qualify as a liability in terms of the definition in the elements Exposure Draft. Some Board members believe that the relevant "past transaction or event" that creates an obligation to transfer assets to (that is, compensate) employees is the illness and that only a potential liability (that is, a loss contingency) exists before the illness occurs. However, the Board concluded that the relevant event is the past event of working; permitting accumulated sick days to be carried forward for use in future periods represents part of the employees' compensation for past work performed. The accumulated amount at year-end is an obligation that leaves the employer with little or no discretion to avoid future payment. Therefore, a liability exists to the extent that some or all of the accumulated sick days are likely to be used. That view parallels the reasoning of FASB Statement No. 5, *Accounting for Contingencies*, which requires a loss contingency to be accrued if (a) it is probable that a liability has been incurred and that future events will confirm the fact of loss and (b) the amount of loss can be reasonably estimated.

15. Notwithstanding the Board's conclusion that accrual of a liability for the probable payment of accumulated unused sick days is appropriate under the liability definition in the elements Exposure Draft, the Board was influenced by respondents' comments that the amounts involved generally would not be large enough to justify the cost of computing the probable payments for nonvesting accumulating sick pay benefits. The Board concluded that accrual should not be required for an obligation related to employees' accumulating rights to receive compensation for future absences that are contingent on the absences being caused by an employee's future illness because, in the Board's judgment, the lower degree of reliability of estimates of future sick pay and the cost of making and evaluating those estimates do not justify a requirement for such accrual. Furthermore, the Board believes that the probable payments for accumulating sick pay benefits rarely would be material

unless they vest or are otherwise normally paid without an illness-related absence (as discussed in the following paragraph), in which cases the benefits would not be dependent on an employee's future illness and the criteria of paragraph 6 would apply. On the other hand, this Statement does not prohibit an employer from accruing a liability for such nonvesting accumulating sick pay benefits, providing the criteria of paragraph 6 are met.

16. The Board believes that the employer's actual administration of sick pay benefits should determine the appropriate accounting. For example, if employees are customarily paid "sick pay" benefits even though their absences from work are not actually the result of illness or if employees are routinely allowed to take compensated "terminal leave" for nonvesting accumulated unused sick pay benefits prior to retirement, the Board believes such accumulated benefits should not be considered as sick pay benefits for purposes of the exclusion described in paragraph 7 but rather should be accounted for in accordance with paragraph 6.

17. Some respondents said that requiring employers to estimate and accrue a liability for compensated absences could be an undue burden for employers, particularly smaller enterprises with limited staff and resources. The Board believes that the accrual accounting specified in paragraph 6 ordinarily will not cause an additional significant record-keeping burden because it centers on employee rights that accumulate or vest. Records maintained by employers for the administration of employee benefits ordinarily will be adequate to provide information for such an accrual. By excluding nonvesting sick pay benefits from required accruals, the Board sought to minimize the estimating burden.

18. Some respondents questioned whether the Board intended this Statement to apply to a sabbatical leave. The Board believes that the appropriate accounting for a sabbatical leave depends on the purpose of the leave. If a sabbatical leave is granted only to perform research or public service to enhance the reputation of or otherwise benefit the employer, the compensation is not attributable to services already rendered (paragraph 6(a)); a liability should not be accrued in advance of the employee's services during such leave. If the leave is granted to provide compensated unrestricted time off for past service and the other conditions for accrual are met, a liability for sabbatical leave should be accrued.

19. Some respondents questioned whether the absence of a reference in the Exposure Draft to the Addendum to Opinion 2 indicated that the Statement would apply to rate-regulated industries. The Board currently is considering the effect of rate regulation on regulated companies in another project. In the meantime, paragraph 3 was added to acknowledge that the provisions of the Addendum govern the application of this Statement to those operations of a company that are regulated for rate-making purposes on a basis of individual company cost of service.

20. Some respondents requested guidance on how an employer should estimate its liability for compensated absences. The respondents asked (a) whether the liability should be based on current or on future rates of pay, (b) whether it should be discounted, and (c) when the effect of scheduled increases should be accrued. The Board noted that it expects to be studying similar issues in its project on accounting by employers for pensions as well as in a possible project on discounting⁴ and, accordingly, concluded to defer a decision on such issues at this time.

21. Some respondents viewed the transition provisions in the Exposure Draft as inconsistent with present generally accepted accounting principles proscribing direct charges to retained earnings. They also expressed the view that required methods of transition should not differ for material and immaterial adjustments. The Board considered those views and changed the transition provisions consistent with several prior FASB Statements.

Footnotes

FAS43, Footnote 1--In this Statement, *vested* rights are those for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service.

FAS43, Footnote 2--For purposes of this Statement, *accumulate* means that earned but unused rights to compensated absences 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.

FAS43, Footnote 3--In accounting for compensated absences, the form of an employer's policy for compensated absences should not prevail over actual practices. For example, if employees are customarily paid "sick pay" benefits even though their absences from work are not actually the result of illness or if employees are routinely allowed to take compensated "terminal leave" for accumulated unused sick pay benefits prior to retirement, such benefits shall not be considered sick pay benefits for purposes of applying the provisions of paragraph 7 but rather should be accounted for in accordance with paragraph 6.

FAS43, Appendix A, Footnote 4--The AICPA is currently developing an issues paper on discounting for consideration by the FASB.