



ARTICLE

# Applying the Right Accounting Model for Pandemic-Related Changes in Workforce & Asset Leases

The business community continues to be affected by COVID-19 and its related economic impacts. Some companies that are negatively impacted may need to restructure their business in order to reduce operating expenditures. Such restructurings may result in terminating employees. This article focuses on the accounting considerations for employee termination benefits.

## **Are the Termination Benefits Considered to be Part of a One-time Arrangement or an Ongoing Benefit Arrangement?**

The threshold question is whether any benefits paid to employees who are involuntarily terminated should be considered to be part of a one-time arrangement that is subject to the guidance in Accounting Standard Codification Topic (“ASC”) 420, *Exit or Disposal Cost Obligations*, or an ongoing benefit arrangement that is subject to ASC 712, *Compensation – Nonretirement Postemployment Benefits*. The answer to that question matters because the different accounting models may result in different timing in the recognition of the related

costs. In particular, ASC 712 generally requires recognition of a liability when it is probable that employees will be entitled to benefits and the amount can be reasonably estimated, which often would occur before the communication date required for recognition under ASC 420.

Determining whether it is an ongoing arrangement requires consideration of both the form and substance of the arrangement. For instance, the benefits may be statutorily required, or otherwise subject to a written policy regarding involuntary termination benefits. Alternatively, the terms of prior layoffs may have established a precedent that creates an expectation on the part of employees of what termination

benefits they will receive. ASC 420 acknowledges this possibility, stating, in part, that “[a]bsent evidence to the contrary, an ongoing benefit arrangement is presumed to exist if an entity has a past practice of providing similar termination benefits.”<sup>1</sup> Termination benefits that exceed past packages may still be deemed to be part of an ongoing benefit plan if such changes are considered to be an enhancement to the ongoing arrangement that is expected to be applicable in the future. Regardless, if there have been layoffs in the company’s recent history, judgment will be required to determine if a past practice of providing similar termination benefits exists, based on an evaluation of the relevant facts and circumstances.

### Accounting for One-time Termination Benefits

A one-time benefit arrangement subject to ASC 420 is deemed to exist at the date the plan of termination meets all the following criteria and the overall plan has been communicated to employees (referred to as the “communication date”), which is not necessarily when individual employees have been notified that they are being terminated as part of the plan.<sup>2</sup>

1. Management, having the authority to approve the action, commits to a plan of termination. This is often based on the date of approval by the Board of Directors.
2. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date. The specific employees need not be named so long as their classifications or functions and location are identified.
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. Similar to the first criterion above, if Board of Directors approval was required, that will typically mean that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

<sup>1</sup> See ASC 420-10-55-1.

<sup>2</sup> See ASC 420-10-25-4.

## — RELATED LEASE ACCOUNTING TOPICS



### Accounting for Early Lease Terminations

Either as a result of a broader change to the needs for office space for employees resulting from the pandemic or because a company that has laid off employees determines it has excess space, companies may decide to terminate leases. While many companies may have prior experience with the accounting for lease terminations, for those companies that have adopted the guidance in ASC 842, *Leases*, the rules around accounting for lease terminations has changed.

ASC 842 amended ASC 420 to exclude costs to terminate a lease from the scope of ASC 420. Under ASC 842, the termination of a lease results in the derecognition of any lease-related assets and liabilities. In addition, any consideration paid or received upon termination that was not already included in the lease payments (e.g., a termination penalty) is included in the calculation of the gain or loss to be recognized upon lease termination. A lease liability is considered extinguished and a gain or loss is recognized when either the lessee pays the lessor and is relieved of its obligation for the liability or the lessee is legally released from being the primary obligor under the liability. At the time of extinguishment, the right-of-use (“ROU”) asset and the lease liability are removed from the balance sheet, with a gain or loss recognized for the difference.

Costs associated with one-time employee termination benefits are measured at the time employees receive communication of the termination. The timing for recognition of those costs is dependent on whether employees are required to render future service in order to receive the termination benefits. If employees are not required to render services until they are terminated in order to receive the termination benefits or if employees will not be retained to render service beyond the minimum retention period, the expense for the termination benefits shall be recognized at the communication date.

Conversely, if employees are required to render services until they are terminated and that service period extends beyond a “minimum retention period,” the 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. 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 generally requires entities with 100 or more employees to notify employees 60 days in advance of covered plant closings and mass layoffs. Collective bargaining or other labor contracts may require different notification periods. In cases where future services are required, judgment may be required in evaluating whether such services are substantive in nature.



## — RELATED LEASE ACCOUNTING TOPICS

### Evaluating Potential Impairments of Right-of-Use Assets

Even if a company has not terminated an existing lease, the pandemic will likely be an economic event that will require the company to evaluate potential impairment of right-of-use (“ROU”) assets for leases. Such ROU assets are subject to the long-lived assets impairment guidance in ASC 360, *Property, Plant, and Equipment*, and as a result a recoverability assessment must be performed if a triggering event is deemed to have occurred. In particular, if current conditions have resulted in a negative impact on the future cash flows associated with the asset group of which the ROU asset is a part, then an impairment analysis for that asset group would be required.

As a reminder, the ASC 360 impairment model is a two-step model, whereby step 1 assesses the recoverability of the asset group using undiscounted cash flows. If step 1 is failed (i.e. estimated future undiscounted cash flows are less than the carrying value of the asset group), then an impairment charge is recorded if the fair value of the asset group is less than the carrying value of the asset group.

If there is an impairment charge, it is allocated to the ROU assets and any other long-lived assets of the group on a pro rata basis using the relative carrying amounts of the various assets, except that the loss allocated to an individual long-lived asset of the group must not reduce the carrying amount of that asset below its fair value. In addition, if a company abandons a ROU asset, to the extent that it was previously evaluated for impairment along with other long-lived assets as part of the same asset group, it will be necessary to reassess whether the ROU asset should still be grouped with those other long-lived assets for impairment assessment purposes, as well as to reevaluate the estimated useful life of the remaining ROU asset.

## Accounting for Termination Benefits Deemed to be Part of an Ongoing Plan

ASC 712 requires a liability for certain termination benefits under an ongoing benefit arrangement to be recognized when they are both probable and reasonably estimable, which often occurs before the communication date requirement for one-time benefit arrangements. Accordingly, benefits attributable to prior services based on the benefit formula are recognized when it becomes probable that the employees will receive the benefit, the amount is reasonably estimable, and the employee’s right to those benefits is not contingent on the employee’s future service.

Conversely, if employees are required to render services until they are terminated in order to receive the termination benefits, the expense would be recognized as the services are provided and the probable and estimable criteria are met. Once again, similar to one-time termination benefits, in any cases where future services are required, judgment may be required in evaluating whether such services are substantive in nature.

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