Alert
Significant Regulatory Developments in Human Resources, Benefits and Compensation
UNITED STATES

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FASB Mandates Accruals for Paid Absences

Employers must accrue an expense for future sabbaticals or similar paid absences over the service period during which the benefits are earned, according to the Emerging Issues Task Force (EITF) Issue 06-2. EITF is part of the Financial Accounting Standards Board (FASB).

Highlights

An employer may provide its employees with a benefit known as a *service award* or *sabbatical leave* that entitles the employees to paid time off after working for a specified period of time with the employer (i.e., the "service period"). During the sabbatical, the individual is not required to perform any duties for the employer but continues to be a compensated. FASB Statement No. 43 requires employers to accrue an expense over the service period for the cost of providing the employees with future compensation during absences if all of the following conditions are met:

- The employer's obligation is attributable to services already rendered;
- The obligation relates to rights that accumulate;
- Payment of the compensation is probable; and
- The amount of payment can be reasonably estimated.

EITF 06-2 does not apply to arrangements in which employees are required to engage in research or public service to enhance the reputation of, or otherwise benefit, the employer. Therefore, some academic institutions and law firms that offer sabbatical programs may not need to accrue the costs of their programs, depending on the provisions of their specific programs.

Measurement

An employer should determine the cost associated with its sabbatical or service award program. The proper valuation of the program under EITF 06-2 will require the use of actuarial methodologies and assumptions. These assumptions will include the incidence of retirement, termination of employment, death, and disability prior to eligibility for the sabbatical. Further, assumed rates of future salary increases will need to be reflected. Lastly, assumptions regarding the timing of taking sabbaticals will need to be reflected.

Example*—An employer allows for two months of paid absence after 15 years of service. Sabbaticals may be taken at any time over the subsequent two years of employment. Employee A who currently earns $100,000 for the year with five years of current service requires an additional 10 years of service prior to becoming eligible for the sabbatical. The employer determines the appropriate actuarial methodology and assumptions to measure the cost of its obligation under the program. It finds its cost for Employee A to be $60,000. Because the employer did not previously accrue an expense for this cost, it makes a* *cumulative-effect adjustment to retained earnings of $20,000 ($60,000 X 5/15). The annual accrual over the next 10 years is $4,000 ($60,000 X 1/15).*

Effective Date

EITF 06-2 will apply to fiscal years beginning after December 15, 2006, as either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or (b) a change in accounting principle through retrospective application to all prior periods.

Actions to Take

Employers that believe they are affected by the EITF 06-2 accrual requirements should take the following actions:

- Review your sabbatical or service award plan documents to determine whether the EITF 06-2 applies. In the absence of definitive language, you should look at how the program has been administered historically.
- Collect data on program experience, specifically for the purpose of determining the appropriate actuarial assumptions to be used to value the program. These data will reside in your human resource information management system, or with the program's administrator.
- Establish an actuarial methodology and assumptions for the purpose of quantifying your obligation under the EITF 06-2. It will be appropriate to perform more than one valuation, in order to understand the sensitivity of using alternative sets of assumptions.
- Discuss with your auditors the results of your valuations, and how the information will be used in financial reporting. Also, gain an understanding of how expense accruals will be adjusted as actual experience under the program occurs.

Questions. If your organization would like to know more about compliance with the new requirement, you can direct comments to Phil Peterson at (610) 834-2169 or Terry Adamson at (610) 834-2280.