

Statutory Issue Paper No. 11

Compensated Absences

STATUS

Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 11

This issue paper may not be directly related to the current authoritative statement.

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not specifically address the accounting for compensated absences (i.e., vested vacation benefits, vested sick pay benefits, and holidays) in either the Accounting Practices and Procedures manuals for Life and Accident and Health or for the Property and Casualty Insurance Companies. The purpose of this issue paper is to establish statutory accounting principles for compensated absences that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

2. A reporting entity shall accrue a liability for employees' compensation for future absences if all of the following conditions are met:

- a. The reporting entity'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 vest¹ or accumulate²,

¹ In this issue paper, vested rights are those for which the reporting entity has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service.

² For purposes of this issue paper, 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.

- c. Payment of the compensation is probable, and
- d. The amount can be reasonably estimated.

3. In the unlikely situation in which a reporting entity does not accrue a liability in accordance with paragraph 2 only because the amount cannot be reasonably estimated (i.e., condition d. is not met), that fact and the reasons therefore shall be disclosed in a note to the financial statements. An employer is not required to accrue a liability for nonvesting accumulating rights for compensated absences as the right to receive these benefits is contingent upon future events and continued employment.

4. A reporting entity shall accrue a liability for employees' compensated absences or, for services reimbursable under service agreements with an affiliate, if all of the above conditions are met.

5. Accounting changes adopted to conform to the provisions of this issue paper shall be accounted for in accordance with *Issue Paper No. 3—Accounting Changes*. In the year the principle is adopted, recognition of the liability for compensated absences at the time of adoption that has not previously been recorded shall be recognized through a direct charge to surplus.

Consolidated/Holding Company Plans

6. The employees of many reporting entities are eligible for certain compensated absence benefits granted by a parent company or holding company. An entity with employees who are eligible for those benefits and is not directly liable for those related obligations shall recognize an expense equal to its allocation from the parent company or holding company of the benefits earned during the period. A liability shall be established for any such amounts due, but not yet paid. Furthermore, the reporting entity shall disclose in the notes to the financial statements that its employees participate in a plan sponsored by the holding company for which the reporting entity has no legal obligation. The amount of expense incurred and the allocation methodology utilized by the provider of such benefits shall also be disclosed. If the reporting entity is directly liable for compensated absence benefits, then the requirements outlined above in paragraphs 2 - 5 shall be applied.

DISCUSSION

7. Paragraphs 2-5 of the Summary Conclusion above adopt *FASB Statement No. 43, Accounting for Compensated Absences* (FAS 43) with certain modifications to paragraphs 8 and 9. Paragraphs 8 and 9 discuss the effective date and the accounting for the retroactive adoption of FAS 43. This issue paper modifies these paragraphs by requiring the initial adoption of this accounting principle to be recorded as a change in accounting principle consistent with Issue Paper No. 3 (i.e., the cumulative effect of the change will be charged to surplus in the year of adoption).

8. Liability, as defined by *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*, is a probable future sacrifice of economic benefit arising from the present obligation of a particular entity to transfer assets or to provide services to other entities in the future as a result of past transactions or events. Compensated absences, which meet the criteria discussed in the conclusion above, meet this definition of a liability. The recording of a liability for compensated absences is also consistent with presenting financial statements which support the Solvency and Conservatism concepts within the Statement of Concepts.

Drafting Notes/Comments

- Holding company obligations are addressed in a separate issue paper.
- Accounting for pensions is addressed in *Issue Paper No. 8—Accounting for Pensions*.
- Employers' accounting for postemployment benefits is addressed in *Issue Paper No. 13—Employers' Accounting for Postemployment Benefits*.
- Employers' accounting for postretirement benefits other than pensions is addressed in *Issue Paper No. 14—Employers' Accounting for Postretirement Benefits Other Than Pensions*.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting Principles

9. Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17, *Other Liabilities*, provides general guidance on the accrual of compensated absences as follows:

Liabilities for Benefits for Employees and Agents

A company may be required or desire to establish a liability for certain benefits to employees and agents which are not provided for in other accounts. Examples include:

The company may wish to set up a liability for the salary for accrued but unused vacation hours since vacation hours can legitimately be viewed as “earned” at the end of the work periods for which they are granted.

10. The Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies does not provide specific guidance on accounting for compensated absences.

Generally Accepted Accounting Principles

11. The accrual for compensated absences is governed by FAS 43, *Accounting for Compensated Absences*. Paragraphs 6, 7, 8 and 9 provide for the determination and treatment of compensated absences.

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 vest¹ or accumulate²,

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.

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.

- 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 benefits³ (that is, compensation for an employee’s absence due to illness) for the reasons stated in paragraph 15.

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.

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.

OTHER SOURCES OF INFORMATION

12. Chapter 22 of the NAIC Technical Resource Group Proposed Draft Life Codification suggested the recording of a compensated absence liability under the following circumstances:

Compensated Absences

Employers pay their employees for absences due to vacations, sick time and holidays. Compensated absences must be accrued if all of the following criteria are met:

- a. the employees have rendered services which obligate the employer to pay for future absences;
- b. the employees are entitled to compensation even if employment is terminated;
- c. payment of the compensation is probable; and
- d. the amount can be reasonably estimated.

Salary advances to an employee can be used to reduce the liability for that employee's compensated absences.

RELEVANT LITERATURE

Statutory Accounting Practices and Procedures

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 17

Generally Accepted Accounting Principles

- *FASB Statement No. 43, Accounting for Compensated Absences*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- NAIC Technical Resource Group Proposed Draft Life Codification, Chapter 22