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Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Period Pension Cost and Net Periodic Postretirement Benefit Cost

FASB Accounting Standards Update No. 2017-07 (Issue Date: March 2017)
Link to Standard: Update No. 2017-07

Overview

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2017-07, *Improving the Presentation of Net Period Pension Cost and Net Periodic Postretirement Benefit Cost*, in March 2017.

This update changes the guidance for employers that sponsor employee defined benefit pensions as well as other postretirement benefit plans. Under the new guidance, employers will be required to present the service cost component of net periodic benefit costs separate from the other components. Service cost is the only component of net benefit cost that originates exclusively from an employee's service to the company during the current period. Therefore, this component will be presented in the same line as other employee compensation costs that arise from services rendered. Other components will be presented separately and outside of any operating income subtotal. Additionally, while the service cost component is still eligible for capitalization, these other components will no longer be eligible for that treatment.

The change is mainly driven by the FASB's belief that presenting pension costs in this manner will provide stakeholders with a better quality of information. This will make it easier for financial statement users to determine the costs arising from services rendered in the period from costs relating to the other components of net benefit costs. Additionally, it will make it easier for users to compare the service costs across companies that have pension plans as well as compare the other components that are driven more by interest, return on assets and amortizations.

It is worth noting that if presented, gross profit, gross margin, and operating income may change significantly for some companies as a result of adoption.

Background

The accounting guidance for compensation relating to retirement benefits is codified in ASC Topic 715. This particular update focuses on subtopics 20 (*Defined Benefit Plan – General*), 30 (*Defined Benefit Plans – Pension)* and 60 (*Defined Benefit Plans – Other Postretirement)*. Prior to this new guidance, companies who sponsored defined benefit pension and/or postretirement benefit plans presented the costs of such plans solely within operating income. Also, various components of those costs were eligible for capitalization.

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The components comprising net periodic benefit cost are as follows;

- Service cost – Actuarially determined present value of benefits accrued during the year
- Interest cost – Interest on the projected benefit obligation
- Actual return on Plan Assets – Difference in fair value of assets from the beginning to the end of the period, net of payments and contributions
- Gain/Loss on settlements/curtailments – The gain or loss stemming from a change in assumptions
- Amortization of prior service cost – Amortization of expense relating to any increase in benefits for past service as a result of any plan amendments

It is noteworthy that the FASB is not changing *how* to measure benefit costs, rather, it is focusing on the presentation of those costs to make the financial data more comparable. The following updates are the most impactful for all entities, including not-for profits;

- If an income from operations subtotal is presented, service cost will be included in other employee compensation within income from operations.

- If the subtotal mentioned above is presented, the remaining components of the net benefit costs will be shown separate from the income from operations. The entity may show those other costs in one line item or break them out individually, as long as an accurate description is given.

- The service cost component is now the only portion that is eligible for capitalization. This will impact some industries more than others, particularly;
    - Financial Services entities that allocate and capitalize portions of compensation cost through deferred assets like loan origination costs
    - Software entities that capitalize labor and compensation costs in the development of their internal-use software
    - Any entities that capitalize compensation costs into inventory or construct a fixed asset internally

- It is important to note that there are no industry-specific exceptions for this update, including rate-regulated companies.

- The update does permit a practical expedient, whereby an employer can use the amounts disclosed in the pension and other postretirement benefit plan note for the prior periods to estimate the costs for retrospective presentation requirements.

An example of the impact on the income statement categories is provided below. There will also be impacts to the balance sheet and statement of other comprehensive income that should be evaluated based on individual company capitalization practices.

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Pension Costs (i)	20XX
Service Cost	50
Interest Cost	8
Actual return on Plan Assets	10
Gain (Loss) on settlements/curtailments	5
Amortization of prior service cost	2
Net period benefit costs	75

(i) from the footnote disclosure or benefit plan statements for this example

	ASU 2017-07		Previous Guidance	
Revenues	$	500	$	500
Cost of Goods Sold		350		375
Selling, general, and administrative		50		50
Income from operations		100		75
Other income, net		75		100
Net income	$	175	$	175

In the above example, all pension cost components are included in operating expenses under the previous guidance. Under the new guidance, only the $50 service cost remains in operating expenses. The additional $25 of pension costs are presented outside of operating expenses.

Insights

This update doesn't change rules on how benefit costs are measured; it merely proscribes how components of pension cost are presented in the financial statements.

While the biggest benefit of this update will be for the stakeholders of financial statements in terms of comparability, companies who rely heavily on metrics, such as EBITDA, gross margin, etc., will need to consider the impact this may have on those calculations.

The guidance has several implications with respect to IFRS convergence. US GAAP will now more closely align with IFRS by requiring the service cost component to be bifurcated from the other components of pension cost. However, IFRS does not specify how to present those costs and still allows the service cost and interest components to be combined in the presentation. A difference also arises due to the new capitalization rules within the US GAAP guidance. US GAAP will limit capitalization to the service cost component, while IFRS will continue to allow all of the components of net benefit cost to be capitalized.

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Final Thoughts

This update will provide more meaningful and comparable information to stakeholders of a company's financial statements. While more line items may now appear on the financial statements as a result of this ASU, the information will be more valuable and comparable across companies. Now, one line-item for pension costs will not be the aggregate of various expenses that vary in how they were derived. Therefore, financial statement users will not have to perform further analysis to isolate the service cost component from other components. We do not believe the change will have a significant impact on efforts surrounding financial statement preparation for most companies.

	Effective Date	
	Public Entity	Non-Public Entity
Interim Periods	Beginning after December 15, 2017	Beginning after December 15, 2019

Early adoption is permitted if financial statements were not issued.

Annual Periods	Beginning after December 15, 2017	Beginning after December 15, 2018

Early adoption is permitted, including during an interim period if financial statements were not made previously available for issuance.

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Please look for future updates on other technical accounting matters at www.fidatopartners.com

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