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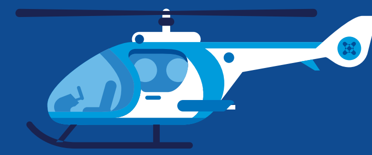

Defining Issues®

FASB separates service cost from other pension cost components

March 13, 2017

KPMG reports on ASU 2017-07[1], which requires a company to present service cost separately from the other components of net benefit cost.

Applicability

All companies that sponsor employee defined benefit pension and other postretirement benefit plans.

Key facts and impacts

The ASU requires companies to present the service cost component of net benefit cost in the income statement line items where they report compensation cost. Companies will present all other components of net benefit cost outside operating income, if this subtotal is presented.

As a result, gross profit and operating income (and related margins) may change significantly for some companies.

Additionally, because service cost is now the only component that can be capitalized, a company that capitalizes retirement benefit costs may need to change the way it determines the amount to be capitalized.

Early adoption is permitted at the beginning of an annual period for which a company has not issued or made available to issue its interim or annual financial statements. A practical expedient makes it easier to retrospectively apply the ASU to net benefit cost for comparative periods by using amounts disclosed in the pension and other postretirement benefit plan notes.

Why change the presentation?

The FASB believes that the revised presentation will provide more decision-useful information about net benefit cost to financial statement users.

Companies will present only service cost in operating income because it is the only component of net benefit cost that originates exclusively from an employee's service to the company during the current period. Therefore, it is generally analyzed differently from other components of net benefit cost.

Entities that do not present a subtotal of operating income can decide where to present the other components. However, they should be presented separately from the service cost component. The presentation should convey the underlying nature of the components. If a separate line item or items are used, they must be appropriately described.

[1] ASU 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost; issued March 10, 2017. Net benefit cost consists of net periodic pension costs and net periodic postretirement benefit cost accounted for under ASC 715, Compensation – Retirement Benefits.

KPMG observation

The assets within which companies capitalize postretirement benefit costs may vary by industry. Our transition example looks at inventory. Many companies, such as those in the manufacturing and telecommunications industries, capitalize retirement benefits in inventory and/or self-constructed assets.

Financial services companies should consider the ASU when determining what costs to include in capitalized deferred acquisition costs or direct loan origination costs. However, the effect may not be significant for loan origination costs accounted for under the guidance for nonrefundable fees and costs.[2]

Additionally, while rate-regulated companies are precluded from capitalizing the other components of net benefit cost in property, plant and equipment, they will continue to capitalize the other components in regulatory assets because they are an allowable cost.[3]

Example: Transition with one comparative period

— A calendar year-end private company will early adopt the ASU in 2017.
— In its 2017 financial statements, it will present comparative financial statements for 2016.
— As of December 31, 2016 and 2015, the portion of net periodic pension cost capitalized into inventory was 25% and 30%, respectively.
— All of the 2015 ending inventory was sold in 2016.

Here is how the company presented its 2016 pension cost in its original 2016 financial statements.

	2016 net periodic pension cost	Less capitalized cost as of 12/31/16 (25%)	Expensed in 2016	Add 2015 capitalized cost sold in 2016*	Total operating expense reported in 2016
Service cost	$20	$(5)	$15	$9	$24
Other components	80	(20)	60	27	87
Total	$100	$(25)	$75	$36	$111

*Based on capitalization of 30% of 2015 net periodic pension cost (details not provided).

2017 financial statements

Unless the practical expedient is applied, the company needs to reclassify the other components cost of $87 from operating expense to nonoperating expense for 2016 in its comparative financial statements.

— The $24 service cost remains in operating expense.
— Because the company applies the ASU prospectively to its balance sheet, all $25 of capitalized pension cost remains in inventory on the December 31, 2016 balance sheet.

A company with multiple inventory cost pools or self-constructed long-lived assets may need to perform a complex analysis to separate the service cost from other costs in the prior periods to properly classify the components of net benefit cost. Some companies may need time to produce the necessary detail to be able to adopt the ASU.

Applying the FASB's practical expedient for transition

The ASU allows a company to use the pension and other postretirement benefit plan note disclosures to apply retrospective income statement presentation requirements. In our example, if the company elects the practical expedient, it would reclassify to nonoperating expense the other components cost of $80 as reflected in the 2016 net periodic pension cost note disclosures.

[2] ASC 310-20, Receivables – Nonrefundable Fees and Other Costs

[3] ASC 980-340-25-1

KPMG observation

Many companies will have other components of net benefit cost capitalized in inventory, self-constructed and other assets on their balance sheet immediately before they adopt the ASU – e.g. capitalized at December 31, 2017 for a January 1, 2018 adoption.

While not explicit in the ASU, we believe that by adopting the balance sheet requirements prospectively, a company will not need to separate the historically capitalized components of net benefit cost. Therefore, a company that applies the practical expedient to comparative periods can choose to continue to include all legacy net benefit costs in operating income as it sells historical inventory and depreciates self-constructed assets in periods after adoption. However, this may reduce comparability for some time after adoption. For example, an entity that applies the practical expedient will present in operating income depreciation expense related to the other components of net benefit cost historically capitalized in long-lived assets until those costs are fully depreciated, possibly over many years.

What else to consider when adopting

Performance metrics and forecasts

The changes introduced by the ASU may have broader effects, including effects on:

- metrics and ratios that measure financial performance such as gross margin, operating profit and EBITDA;
- comparative profit margins;
- contractual arrangements (e.g. loan agreements, earnouts or bonuses) and amounts accrued for these obligations; and
- how public companies discuss significant trends in MD&A.

Accumulated other comprehensive income

Actuarial gains and losses related to pension and other postretirement benefits that are amortized out of accumulated other comprehensive income can no longer be capitalized and will be reclassified to net income in their entirety.

A company will disclose the reclassifications out of accumulated other comprehensive income under comprehensive income accounting guidance.[4] We believe a cross-reference to the related pension or other postretirement benefits note is no longer necessary because the ASU requires a company to either present the components other than service cost in a separate line item or items in the income statement or to identify the line item(s) used in the income statement to present them.

Termination benefits, settlements and curtailments

The accounting for termination benefits depends on whether the costs will be paid under an ongoing plan, a contractual arrangement or a one-time benefit arrangement. A company will generally include termination benefits in operating income unless they fall under postretirement benefit guidance.

Because restructuring plans often involve activities within the scope of exit and disposal activities, and pension and other postretirement benefit accounting guidance, a company will need to use judgment when presenting these costs in the income statement.[5]

- A company presents one-time termination benefits associated with an exit activity in operating income with its restructuring charge.
- Plan settlements and curtailments, which often occur with a restructuring, are accounted for under pension and postretirement benefit accounting guidance and will be presented outside operating income.

[4] ASC 220-10-45-17A and 45-17B

[5] ASC 715, Compensation—Retirement Benefits; SEC SAB Topic. 5.P.3, Miscellaneous Accounting: Restructuring Charges, Income Statement Presentation of Restructuring Charges

Differences remain between US GAAP and IFRS

Significant differences remain between US GAAP and IFRS with respect to the presentation of actuarial gains and losses and prior service costs. However, presenting service cost as compensation cost aligns more closely with presentation under IFRS.

Effective dates

	Public business entities	All other entities
Annual periods – Fiscal years beginning after	December 15, 2017	December 15, 2018
Interim periods – Fiscal years beginning after	December 15, 2017	December 15, 2019
Early adoption allowed?	Yes, for annual periods for which a company has not issued or made available to issue its interim or annual financial statements. A calendar-year **public business entity** is permitted to adopt as of January 1, 2017 in its Form 10-Q for the first quarter of 2017. A calendar-year **nonpublic entity** could adopt as of January 1, 2016 if it does not issue interim financial statements and has not yet issued (or made available to issue) its 2016 annual financial statements.	

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KPMG's Financial Reporting View

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