Pension rule changes may improve operating margins

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In brief

The Financial Accounting Standards Board (FASB or the Board) issued today a new standard on the presentation of net periodic pension and postretirement benefit cost (net benefit cost). Under existing guidance, all elements of benefit costs are reported as an employee cost within operating income. The new amendment requires all employers to separately present the service cost component from the other pension and postretirement benefit cost components in the income statement. Service cost will now be presented with other employee compensation costs in operating income or capitalized in assets, as appropriate. The other components reported in the income statement will be reported separate from the service cost and outside of income from operations.

The amendments are effective in 2018 for calendar-year public business entities and in 2019 for calendar-year other entities. Early adoption would be permitted, although only in the first interim period of a fiscal year, if interim financial statements are issued.

In detail

Background

Net benefit cost includes several components, including current period employee service cost, interest cost on the obligation, expected returns on plan assets, and amortization of various amounts deferred from previous periods. Under existing guidance, these components must be aggregated and reported net as employee compensation cost.

The FASB received feedback from some stakeholders that this aggregate presentation combines elements that are distinctly different in their predictive value, resulting in greater cost and complexity when analyzing financial statements.

In response, in early 2016 the FASB proposed changes to the presentation of the net benefit cost (refer to HRS Insight, *FASB proposes improvements to the financial reporting of pension and OPEB benefits*). The Board decided to move forward with changes to these presentation requirements and issued today the new standard.

It's important to note that the FASB is not changing the rules related to the timing of when costs are recognized or how they are measured. This amendment only impacts where those costs are reflected within an employer's income statement, as well as which costs are eligible for capitalization into inventory, internally-developed software, etc.

Presentation of net benefit cost

Under the new rules, entities that sponsor defined benefit plans will present net periodic benefit cost as follows:

1. disaggregate service cost from the net benefit cost and include with other employee compensation costs,
2. separately present the other components of cost outside of income from operations (if such a subtotal is presented), and

3. capitalize only the service cost component, where applicable (for example, as a cost of inventory or a self-constructed asset).

The other components of net benefit cost could be in one or more than one line item. If a separate line item is used to present the other components, it should have an appropriate description. Disclosure must be made as to where the costs are classified if not in a suitably-labelled separate line item.

Observation

The changes will affect all companies that sponsor pension and OPEB plans, but companies that immediately recognize gains and losses (i.e. mark-to-market) will likely be more significantly affected as these gains and losses will no longer be included in operating results. Companies that capitalize net benefit cost may also see a greater impact since only service cost will be capitalized.

Companies should consider the impact these changes will have on systems and processes, and consider the impact on gross and operating margins of only including service cost in operating results or of only capitalizing the service cost component.

Companies should also consider how these changes may impact intercompany billing arrangements and any tax consequences as profits may shift from one entity to another.

Applicable for all entities

The new guidance is applicable for entities that sponsor pension or OPEB plans. The FASB considered, but rejected, providing exceptions or alternatives for certain types of companies (such as regulated utilities or government contractors). The guidance will apply equally to all entities.

Curtailments, settlements, and termination benefits included with other components

When a benefit obligation is settled, a gain or loss is recognized in income representing the acceleration of a portion of deferred gains or losses associated with the obligation. Under the new rules, these settlement gains or losses will be included in the other components of cost outside of income from operations.

Similarly, when a curtailment is triggered (where either the expected years of future service of current employees is significantly reduced or the accrual of defined benefits for some or all future services of a significant number of employees is eliminated), the gain or loss associated with the curtailment would likewise be reflected in the other components of cost outside of income from operations.

Finally, costs of termination benefits provided through a retirement benefit plan will be included in the other components of cost outside of income from operations. This presentation will differ from the presentation of similar termination benefit costs that are not funded through the retirement plan, which will continue to be recognized as employee costs in operating results.

Observation

As noted, the design of an employer's termination benefit program will impact how the costs are presented in the income statement once these amendments are effective. Employers should review existing arrangements to determine whether severance benefit programs will fall under the new guidance, and consider whether plan design changes are warranted.

Administrative costs

The existing rules don't prescribe how most types of costs of administering a plan should be presented. Consequently, we see diversity in practice in how employers present these costs.

Some reflect the cost of administering the benefit plan (e.g., costs incurred to administer the plan participant's database or actuarial valuation cost) in the period when the services are provided and include these amounts in the service cost component of net benefit cost. Others recognize this cost separate from the accounting for the plan if funded outside the pension trust. Further, costs of managing the benefit plan assets (e.g., investment management fees) are often reflected as an adjustment to expected returns on plan assets.

The FASB did not address how these administrative costs should be reflected under the amendments. As a result, we anticipate diversity in presentation will continue.

Observation

Service cost is currently defined as 'the actuarial present value of benefits attributed by the pension benefit formula to services rendered by employees during the period.' This definition has not changed as a result of the amendments. With the heightened distinction and prominence between service cost and the other benefit cost components under the amendments, some may reconsider whether continuing to reflect administration costs as part of service cost is appropriate.

Affiliated entity reporting or carveouts

When an entity participates in a pension or postretirement benefit plan sponsored by an affiliated entity (e.g., parent company, sister subsidiary, etc.), the accounting in standalone financial statements of that entity should generally follow the 'multiemployer' guidance. This approach is also used in carveout financial reporting in many cases.

Under multiemployer accounting, an entity would typically recognize expense based on the required contribution to the plan for the period and would only recognize a liability to the extent that the required contribution had not been paid at the end of the period. The new FASB rules will not affect the classification of amounts recognized under multiemployer accounting.

The 'required contribution' may reflect actual cross-charges made by the sponsoring entity to the other participating entities for pension and postretirement benefits, or otherwise may represent a reasonable allocation of the parent company's net benefit cost (generally calculated as some allocation of total net benefit cost).

Observation

The total amount recognized in the affiliated entity financial statements or carveout financial statements (if the multiemployer approach is used) should be presented in operating income (if a company presents such a caption), even if the amount allocated is based on the total net benefit cost.

Discontinued operations

The discontinued operations guidance may require companies to present costs associated with a disposal business to be presented in discontinued operations. Companies that are presenting discontinued operations may still allocate the non-operating components to discontinued operations if directly related to the disposed business.

Effective date and transition

The amendments will be effective for annual and interim reporting periods beginning after December 15, 2017 for public business entities and for annual reporting periods beginning after December 15, 2018 for other entities. Additionally, early adoption will be permitted as of the beginning of an annual period.

Observation

Companies that would like to early adopt the amendments must do so in the first interim period in the year of adoption, if interim financial statements are issued.

The amendments will be applied retrospectively for the presentation of service cost and the other components of net benefit cost, and prospectively for the capitalization of only service cost. Any amounts capitalized prior to the adoption date will continue to be amortized/recognized in income in the same fashion as before. As a practical expedient, the amendments permit companies to disaggregate the service cost from the other components for prior comparative periods based on amounts disclosed in the prior period footnotes. A company using the practical expedient will need to disclose that it was used.

Observation

This practical expedient was provided because there was concern that companies that capitalize costs would have difficulty in identifying how much of each cost actually went through the income statement. Additionally, companies that allocate cost to operating units may be unable to track the individual components of net benefit cost.

Next steps

Companies will need to decide if they will early adopt in 2017. Companies will also need to determine the broader implications to the amendments – such as how the amendments will impact systems and processes, company margins and any tax consequences.

The takeaway

Changes to presentation of benefit costs are coming, and could significantly impact operating earnings of many companies. While accounting changes associated with revenue recognition, leasing, and credit losses will be the focus of many financial executives over the next 12 months, these retirement benefit reporting changes could also have a significant impact on financial reporting.

Let's talk

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