Major Changes Proposed to Accounting Standards for Private Enterprises and Not-For-Profit Organizations

Last year, the Canadian Accounting Standards Board (AcSB) released a strategic plan for overhauling various aspects of the national accounting standards and a review of the transition to International Financial Reporting Standards (IFRS) that publicly accountable enterprises have been undertaking over the last several months.

As mentioned in our memo last year, one of the areas addressed by the strategic plan was a major improvement in the accounting of employee benefits. It was clear from the title of the document that the intent was indeed a major change from current practice, given that the project was called "Watch for proposals to abolish smoothing!"

A few days ago, the AcSB released the exposure draft for the project which delivers on its promise to completely remove smoothing mechanisms from benefits accounting in Canada starting in 2014. The exposure draft would apply to private enterprises as well as not-for-profit organizations that are currently using CICA 3461.

The changes announced will bring a lot more volatility to benefits accounting but, for those closely following accounting developments around the world, this is no surprise. In fact, US GAAP adopted a mark-to-market methodology in the balance sheet several years ago and such a methodology will be mandatory in IFRS next year. This proposal simply follows what has been done around the world, but with a few small tweaks.

Overall changes

As we pointed out in our last memo, private enterprises currently have the option either to recognize gains and losses over an extended period of time using smoothing mechanisms or recognize them immediately. Smoothing mechanisms alleviate some of the volatility of the pension plan in the employer's financial statements, especially in these times of high economic uncertainty. The proposal in the exposure draft will dramatically increase uncertainty and remove the ability for corporations to forecast or finalize the year's pension/benefit expense before the fiscal year is completed. On the other hand, the intent of these changes is to simplify and increase transparency of accounting results.
Recognition

The AcSB proposes to require the immediate recognition of all changes in plan assets and in the plan obligations of employee defined benefit (DB) plans. That means all actuarial gains and losses would be recognized immediately and in full in the financial statements for the period in which they occur. The existing option to defer recognition of gains and losses (the "corridor approach") will be removed. In addition, all past service costs will have to be recognized in the period in which the plan amendment is adopted.

This brings Canadian GAAP in line with other accounting standards for post-employment benefits, such as US GAAP and IFRS (with IAS amendments that will be effective in 2013). It will mean that the balance sheet item with respect to the long-term employee benefit plan will reflect the actual surplus or deficit within the plan.

It is very important to note that the current proposal will maintain the ability to use funding (going concern) assumptions, in addition to the traditional corporate bond rates methodology, to calculate the value of the liabilities. This is important for two reasons:

1. **Reducing the cost of producing accounting results** – This will enable plan sponsors to use the results of the funding valuation instead of having the plan's actuary calculate a new set of liabilities as of the year-end with a new set of assumptions.

2. **Tempering the volatility of accounting results** – Under most accounting standards, plan obligations are valued using corporate bond rates, which can be very volatile from year to year. Allowing a funding rate approach will remove the volatile nature of corporate bond rates and replace it with a rarely changed funding rate which is based on a long-term return on assets.

Lastly, the proposal would eliminate the choice regarding the date at which the fair value of plan assets and the defined benefit obligation are measured (currently it can be up to three months before the year-end date). Several sponsors use a different "as of" date for measuring the defined benefit obligation and assets. However, not permitting the use of an earlier date may make it difficult to prepare employee benefits accounting disclosures within the usual tight year-end deadlines.
Income Statement

The changes described above will also greatly impact the income statement. As gains and losses are immediately recognized in the balance sheet, they need to be recognized immediately in the income statement. In short, any investment and/or demographic gains or losses must be recognized in the year they occur as well as any plan improvement. The table below summarizes the proposed changes and how they compare to the current methodology.

<table>
<thead>
<tr>
<th>Components</th>
<th>Descriptions</th>
<th>Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Service Cost</td>
<td>Cost of benefit accrual during the fiscal year for all participants</td>
<td>None</td>
</tr>
<tr>
<td>Finance Cost</td>
<td>Interest charge on surplus/(deficit) using the rate used in calculating the obligation on liabilities offset by the expected return on plan assets applied to assets</td>
<td>Combines the interest cost and expected return on assets on the surplus/deficit using one interest rate</td>
</tr>
<tr>
<td>Remeasurement</td>
<td>Experience gains and losses, including changes in assumptions, Settlement and curtailment gains and losses, Plan amendments (prior service cost), Changes in valuation allowance</td>
<td>Eliminates gain and loss amortization as well as prior service cost amortization</td>
</tr>
</tbody>
</table>

Conclusion

The AcSB is requesting comments from the public by May 25 on the direction it is taking with this exposure draft. Aon Hewitt will contribute to the process and continue to keep you apprised of further developments. A sponsor that is committed or obligated to maintain a benefit plan should study the impact of moving to "mark-to-market" accounting and the resulting consequences for their business, such as potential consequences on contractual arrangements and financial ratios.

As in all changes, this announcement is a good opportunity for sponsors to reflect on their current practices. All stakeholders in the benefit accounting world will need to reassess the way they view the cost and volatility of benefit plans, as they did with past changes.

Should you wish additional information on this topic, please contact your local Aon Hewitt Consultant, or send an email to info@aonhewitt.com.