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The Future Of Benefit Plans In Canada

By: Dan Clark

You've probably noticed the prevalence of stock options in recent business news headlines, as companies deal with the fall-out from the backdating of stock options. However, stock options are not the only area of employee **benefits** that CFOs will have to be concerned about in the coming months.

Twenty years ago, **accountants** and actuaries introduced standards for reporting future employee **benefits**. They've made minor adjustments in the past, but the next few years will see significant changes to these standards. Just as stock options have come under greater scrutiny by **investors** and regulators, future employee **benefits** have become a target for change.

Future employee **benefits** include not only traditional **pension plans**, but also the medical and dental **benefits** that companies provide to their **retirees**. Post-**retirement** life insurance is also offered by some companies. Up until the early 1990s, companies were expensing these **benefits** on a cash basis. In the late 1980s and early 1990s, U.S. **accounting** standards were revised from a cash **accounting** basis to a basis that would reflect the true cost of these plans over the employee's working lifetime. To soften the blow, the **accounting** standards provided for a transition period to allow companies to gradually reflect the impact over a period of time. In addition, the standards allowed any subsequent losses or gains, as well as the cost of any **benefit** improvements, to be smoothed over a number of years.

The outcome of all this smoothing was that the true funded position of the plans was not being recognized in the company's balance sheet. Now that **investors** have realized this, they are demanding changes to the standards.

Where We Are Now

In 2006, the U.S. accounting standards were revised. Companies are now required to report the funded position of their post-retirement employee benefit plans in the balance sheet, not just in the footnotes. We expect that the Canadian accounting standards will undergo a similar revision in 2007.

The trend to full reporting of the funding position of employee post-retirement benefit plans is a global one. It's expected that all companies reporting under international, U.S., or Canadian accounting standards will eventually have to include the true funded position of their post-retirement plans in the balance sheet.

Reporting the true funded position of employee post-retirement benefit plans will result in many companies reporting deficits. In many cases, these companies will want to review their plans and develop strategies to lower the deficits. The bad news is that it's very difficult to reduce medical and dental benefits for current retirees in Canada. Ontario courts have ruled that companies have an obligation to continue current medical and dental programs for existing retirees, even when the company has wound up its Defined Benefit pension plan. And, convincing retirees to accept a buy-out of their post-retirement medical and dental coverage is a hard sell.

How Employees Are Affected

Gone are the days when companies blindly promised life-time coverage for medical and dental benefits. Most companies didn't fully appreciate the long-term impact of granting these benefits when they first offered them in the last quarter of the 20th century. Benefit reduction – or even the elimination of post-retirement medical, dental, and life insurance benefits – is a real concern for future new retirees.

Younger employees will also see a trend towards replacing traditional DB pension plans with Defined Contribution plans. CFOs don't like volatility, and the DC plan provides a much less volatile company expense than the traditional DB plan. While DC plans still experience volatility, it's the employee that has to deal with the effects of this volatility – not the employer.

Older employees can expect that employers will try to limit their costs for existing post-retirement benefits. For example, employers may introduce lifetime maximums, annual caps on benefits, or some form of cost-sharing with employees for medical and dental plans. Post-retirement drug plans may be revised to limit the selection of drugs covered. Out-of-country coverage for retirees may be dropped.

Assuming that post-retirement benefit plans aren't eliminated entirely, both older and younger employees can expect changes to the early retirement benefits. It's likely that new retirees will have to retire at a later age than the current baby boomers in order to receive an unreduced pension and that Factor 80 retirements will become a thing of the past.

Employees not covered by a collective agreement may be the first to lose their post-retirement benefits. Already, many companies with non-unionized employees have converted their DB pension plans to DC plans. While reducing or eliminating benefits for unionized employees is one way to lower costs, any reduction would have to be negotiated with the union during collective bargaining.

We've recently seen examples of unions agreeing to pay cuts in order to preserve jobs and it may only be a matter of time before unions accept cuts to their post-retirement benefits as well. In Canada, unions have traditionally supported DB pension plans. However, they may be forced to accept DC plans in order to preserve jobs.

Multi-employer Plans Another possible outcome of future collective bargaining is an increase in multiemployer pension plans. There are several versions of these plans, from union-sponsored pension plans to plans jointly-sponsored by a union and the employers. Typically, the employers' contributions are collectively bargained and the plan's trustees establish the benefit levels that can be sustained by these contributions. For employers, these plans provide predictable employer contributions similar to the contributions to a DC plan.

Post-retirement benefit plans have always been expensive, but the true impact of these plans wasn't always obvious to investors. Over the next few years, there will be significant changes to how these plans are reported and expensed.

Determining the funded position of post-retirement benefit plans requires an actuarial valuation of the liabilities, a valuation based on long-term corporate bond yields. Each year, the bond yields could change, introducing volatility to the balance sheet. Once smoothing is eliminated from the determination of the annual expense recorded in the income statement, companies may also see increased volatility in the income statement.

The accounting standards boards are taking a cautious approach to reforming the income statement. It's possible that a compromise may result, a compromise that will provide some stability to the income statement, but at the cost of increased volatility in the balance sheet. One option would be to recognize any gains and losses not as an element of current year expense, but as an adjustment to shareholder equity.

Companies should pay attention to the ongoing debate on how post-retirement benefits should be expensed by publicly-traded companies. While investors and CFOs may accept volatility on the balance sheet, they are less likely to accept volatility on the income statement. And the provincial and federal governments have their own motives to follow the discussions.

The current retirement plan structure in Canada depends upon a partnership between the individual, the government, and the employer. As employers decrease their post-retirement benefits, the individual and the government will have to compensate. Since any reductions to post-retirement benefits will probably coincide with a reduction in total overall compensation, individuals may not have much opportunity to make up the shortfalls. Voters will look to the government to fill the void.

Taking Action If companies abandon the retiree benefit field, and if individuals must become more self-reliant, then the Income Tax Act should be revised to allow for a tax-efficient savings plan that can be used by retirees to pay for medical and dental coverage. To make the paying field level, the Income Tax Act could also allow companies to pre-fund these benefits in a tax-efficient manner.

At the time of the last election, the CIA tried to push pensions onto the political agenda. With a new election on the horizon, now is the time for the political parties to consider an overhaul of the retirement benefit structure – whether by creating new saving plans to finance retiree medical and dental plans, or by expanding the Canada Pension Plan benefits to fill the void left by employers who eliminate or reduce their employee pension plan benefits. ■

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