

# Opportunities for DB Plan Sponsors Under New CICA Accounting Standards

For fiscal years starting in 2011, many Canadian organizations that are not moving to International Financial Reporting Standards (IFRS) will be adopting the new Accounting Standards for Private Enterprises of the Canadian Institute of Chartered Accountants (CICA). This Spotlight, written specifically for finance professionals, outlines the opportunities that the new accounting rules may present for organizations that provide employee future benefits<sup>1</sup> through one or more Defined Benefit pension plans.

The new CICA standard presents the following opportunities:

- **Reducing the Pension Cost for Future Years** – The transitional rules allow an immediate adjustment to retained earnings for existing unrecognized losses or prior-service costs, an option that avoids reporting those amounts on the income statement. For companies that can withstand the balance-sheet hit, this provides an opportunity to eliminate existing pension-related amortizations, thereby increasing reported profits going forward. (For a company with unrecognized gains, there is no requirement to adjust retained earnings and, consequently, the amortizations will continue to reduce the pension cost going forward.)
- **Boosting/Protecting the Balance Sheet** – The other side of the option described above may be more important for benefit plan sponsors with significant borrowing needs or loan covenants. A company with unrecognized gains from DB plan has the option to use those gains to increase retained earnings. Meanwhile a sponsor with unrecognized losses and/or prior-service costs is not required to take a hit.
- **Removing Compliance Worries for Smaller Plans** – Many organizations have historically avoided reporting detailed costs for their DB plans on the grounds that they are immaterial. Where the DB plans have grown, or are expected to grow, relative to the size of the sponsor, the adoption of the new standard provides an opportunity to move to full compliance with the CICA requirements for employee future benefits. Auditors may approve the change this year with fewer disclosures and recalculations than at other times.
- **Creating Consistency with the Funding Cost** – The new rules allow plan sponsors the option to base accounting figures on going-concern funding liabilities, subject to certain additional conditions.
- **Aligning with Other Accounting Standards** – For subsidiaries of companies required to report under alternative accounting standards, such as U.S. GAAP or IFRS, it may be possible and desirable to select options that better align the reported results with the consolidated figures presented by the parent. Similarly, for private enterprises considering an initial public offering, closer alignment with IFRS may also be possible and attractive.

Using a funding valuation to derive the accounting figures may lead to very different results from the existing approach. Often there may be a clear increase or decrease in the expected pension cost in the near term. However, near-term cost savings should not be the only factor to determine whether or not to base accounting figures on funding results.

Arguments for using funding results include:

- **Improvement in Balance Sheet Position** – The discount rates used for going-concern funding valuations tend to be higher than typical accounting discount rates.
- **Reduced Exposure to Volatility in Corporate Bond Yields** – The discount rates used for going-concern funding valuations tend to vary less over time than typical accounting discount rates that are tied directly to corporate bond yields.
- **More Compatible with Certain Liability-driven Investing Techniques** – Accounting and funding risks can be hedged together.

- Simpler Communication of the Cost of the Plan – There are fewer measures of cost. It is the lesser of two evils.
- Lower Professional Fees – Separate accounting liability valuations are not needed.

Arguments against using funding results include:

- Gains and Losses and Prior Service Costs Cannot be Deferred and Amortized – This is not permitted if funding results are used.
- Greater Exposure to Asset Volatility – Asset smoothing is not permitted if funding results are used; the market value of assets must be used.
- More Challenging Planning – The use of an early measurement date (e.g., September 30 for a December 31 year end) is not permitted under this option.
- More Detailed Calculations May Be Needed for Special Events – Examples include layoffs, large annuity purchases and plan changes.

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<sup>1</sup> Employee future benefits refers to benefits an organization provides to employees once they have left active service. The term encompasses pensions and benefits such as the following: other post-employment benefits, severance benefits and disability benefits.

<sup>2</sup> For a more general discussion of the new standards, please see the CICA's Guide to Accounting Standards for Private Enterprises in Canada: <http://www.cica.ca/privateenterprises/site-utilities/item39844.pdf>