

# **Implementation of New Disclosure Requirements by FSCO**

## ***Disclosure Expectations for Pension Plan Financial Statements Filed in Ontario For years ending on or after July 31, 2013***

### **1. Introduction**

On March 21, 2014, the Financial Securities Commission of Ontario (“FSCO”) published revised<sup>1</sup> *Disclosure Expectations for Financial Statements Filed Pursuant to Regulation 909 s.76*. The Guidance Note provides regulatory guidance for certain principles-based requirements set out in the CPA Handbook Section 4600 - Pension Plans, and to specify FSCO’s expectations with respect to disclosures provided in pension plan financial statements filed in Ontario.

These requirements are effective for pension plans with years ending on or after July 31, 2013. Pension plans with December 31 year ends are required to comply in their 2013 audited financial statements.

The disclosure requirements vary depending on the type of pension plan and the size of the pension plan. For many plans the disclosure requirements will be significant. The greatest impact is for defined benefit pension plans with assets in excess of \$10 million at December 31, 2013.

**PwC observation.** This guidance has been under consideration by FSCO for some time. Prior to the final release we thought the regulator may be willing to provide some relief from the most significant disclosures. In the final rules there was no relief. Clarifications on how to apply these new reporting requirements is included have been included in this newsletter.

### **2. Applicability**

The final guidance softened its title from “Disclosure Requirements” to “Disclosure Expectations”. However, we understand FSCO expects this guidance will be treated as a requirement,

*FSCO will consider, on a case by case basis, submissions from administrators that provide support for disclosure that varies from FSCO’s expectations described in this Guidance Note, but are appropriate for the pension plan.*

We understand FSCO expects the Guidance note to be applied by plans that provide either pension plan or pension fund financial statements. FSCO will accept pension plan or pension fund financial statements that are filed under Section 76 of the Regulation. Pension fund

<sup>1</sup> Initial Guidance Note, was released in February 2013.

statements do not disclose actuarial liabilities.

**PwC observation.** We believe the Guidance Note to be a policy extension of Regulation 909 s.76. To be in full compliance with Regulation 909 c.76 financial statements should comply with the Guidance Note.

Smaller pension plans with assets less than \$10 million measured at fair value at year end have relief from certain disclosure requirements. This newsletter focuses on those plans with assets of \$10 million or greater which are expected to fully comply with the Guidance Note.

**PwC observation.** The Guidance Note also provides the option of including the disclosures in other documents filed with the Regulator, such as the management discussion and analysis (MD&A). However, such disclosures are to be incorporated by reference in the financial statements and therefore would be subject to audit. Most pension plans do not prepare an MD&A for filing with the Regulator, so this newsletter assumes that there is no MD&A filed with the Regulator, and that disclosures, if provided, will be included in the notes to the financial statements.

### **3. Specific Disclosure Requirements**

The Guidance Note specifically addresses the following disclosure requirements:

- Statement of Changes in Pension Obligations
- Interest in a Master Trust
- Capital Management (including Statement of Investment Policies & Procedures (SIP&P) and Contributions)
- Financial Instruments: Disclosures

#### **a) Statement of Changes in Pension Obligations**

Canadian GAAP for defined benefit pension plans (CPA Handbook Part IV - Section 4600) requires pension plan's financial statements to present pension obligations and the resulting surplus or deficit on the face of the Statement of Financial Position. A Statement of Changes in Pension Obligations is also required.

FSCO will accept Pension Fund financial statements, ie. omitting actuarial liabilities. When financial statements are prepared for regulatory filings (as pension fund financial statements), the Statement of Financial Position (which excludes actuarial liabilities), is generally renamed the "Statement of Net Assets Available for Benefits".

**PwC observation.** We most often see pension plan financial statements being prepared on a fund basis, omitting actuarial liabilities – as the actuarial information is available to the Regulator through the actuarial filings and the fund basis saves in the time and cost of preparation of the audited financial statements. Clients are generally using the title of "Statement of Net Assets Available for Benefits".

When the financial statements are prepared on a fund basis the departure from GAAP (CPA Handbook Part IV- Section 4600) is required to be disclosed in the notes.

FSCO expects the auditor's report to:

- state that the financial statements are prepared in accordance with the financial reporting provisions of Section 76 of Regulation 909 of the Pension Benefits Act; and
- include a paragraph on the restriction on use.

**PwC observation.** Fund financial statements have generally complied with these requirements already. However, by requiring the audit opinion to state that the financial statements are prepared in accordance with the Regulation, we believe that this includes compliance with the Guidance Note. **As a result, a significant departure from the Guidance Note would typically lead to a qualification in the auditor's report.**

**b) Interest in a Master Trust**

Handbook Section 4600 no longer allows the use of proportional consolidation or equity accounting for a Master Trust in the financial statements. An interest in a master trust must be presented as a single line on the statement of net assets. FSCO expects detailed disclosure of the holdings of the Master Trust in the notes.

**PwC observation.** Most pension plans that invest in Master Trusts already comply with these requirements. We do not view this as significant change.

**c) Capital Management (including SIP&P and Contributions)**

The Guidance Note requires significant expansion of capital management disclosures. In addition to the previous disclosures provided, FSCO expects detailed disclosures around how the investment portfolio is managed; specifically the following disclosures should be included with respect to the SIP&P:

- a statement that the administrator has adopted a SIP&P and the date when it was established;
- the date the SIP&P was last amended;
- if a SIP&P has not been established as required, a statement that the plan does not have one;
- if the SIP&P was amended during the period covered by the financial statements, the details of the change;
- a description of the following included in the SIP&P:
  - categories of investments and loans referred to in the SIP&P
  - asset mix targets
  - rate of return expectations
  - investment options offered to plan members of a defined contribution plan
- a measurement of the results achieved by the administrator during the period related to targets or benchmarks included in the SIP&P; and
- a statement that the pension plan investments fell within the asset mix target ranges for a defined benefit plan as at the end of the year (or that it has not, and an explanation why it has not).

**PwC observation.** This new guidance will likely result in significant additional note disclosure for most plans. FSCO has indicated that it does “*not anticipate that the administrator will need to develop a new set of data or statistics, as the administrator can rely on information that was already provided internally to key management personnel.*”.

It is therefore important for the administrator to obtain its SIP&P and identify both (i) the information available to the administrator and (ii) plan specific data used to monitor the SIP&P. This information and data will determine the extent and nature of required disclosures.

The extent of audit work that will be required will depend on the level of detail provided in this note disclosure and who prepares data. For example, rate of return ratios or percentages prepared by a third party custodian or investment manager may require less audit effort than those produced internally.

#### **d) Financial Instruments: Disclosures**

Pension plans are required under Canadian GAAP to provide disclosures around their investment portfolios in accordance with *IFRS 7 – Financial Instruments: Disclosures*. The Guidance Note reinforces these requirements, and provides specific application guidance.

The Guidance note provides extensive new requirements for investments in pooled funds. FSCO has stated:

*Administrators who invest in pooled funds may rely on the disclosure provided in the audited financial statements of the pooled funds in which the pension fund is invested. The statements for the pension fund should reflect a proration of the plan’s/fund’s share of each pooled fund’s disclosure impact on the pooled fund’s Net Assets Value (NAV) and be aggregated for each of the risk variables.*

*When a pooled fund uses a different level of reasonable possible change than those set out in this Guidance Note, the plan administrator would be expected to prorate the impact for the plan’s disclosure.*

A pension plan holding pooled funds is required to provide disclosures of investments held by the pooled fund, ie. by “looking through” the pooled fund to the underlying investments.

Detailed examples are provided in the Guidance Note.

**PwC observation.** Under IFRS 7, the pooled fund unit held by the pension plan is the financial instrument, and there is no requirement to “look through” to the underlying financial instruments held in the pooled fund for risk disclosures. FSCO’s requires pooled funds to “look through” to the underlying investments in the pool funds and provide incremental disclosure.

The FSCO guidance does not contain a definition of a pooled fund. In our view a reasonable interpretation would be to use a similar definition used by the FSCO or the Ontario Securities Commission for regulatory purposes. This definition excludes limited partnerships, private funds, etc. – funds that do not fall under National Instrument 81-106.

The underlying principle in the preparation of these disclosures is that “*FSCO does not anticipate that the administrator will need to develop a new set of data or statistics, as the administrator can rely on information that was already provided internally to key management personnel.*” Based on this guidance we believe FSCO may accept more limited disclosures of the investments held in pooled funds if the administrator manages its investments in such a manner. However, we believe FSCO expects these situations to be rare.

Where the audited financial statements of the pooled funds are available, FSCO will expect that the note disclosures will be provided.

The most significant impact of this requirement will be on defined benefit pension plans that hold pooled funds. Defined contribution plans, where the members direct their investment decisions, are exempt from much of these disclosures.

The disclosures provided for pooled funds should contain similar disclosures to those required if the investments were held directly. Specific requirements are:

- a credit ratings schedule of interest-bearing financial instruments (AAA, BBB etc.);
- a maturity analysis of interest-bearing financial instruments;
- a sensitivity analysis of the foreign currency denominated financial instruments, with regard to a possible change of 5 per cent in the foreign currency exchange rate (one analysis for each applicable foreign currency subject to the materiality requirement);
- a sensitivity analysis of interest-bearing financial instruments, with regard to a possible change of 1 per cent in the overall level of interest rates;
- a sensitivity analysis of equity financial instruments, with regard to a possible change of 10 per cent in the appropriate equity index benchmark (one analysis for each applicable category of equity investments permitted by the SIP&P and subject to the materiality requirement); and
- the methods and assumptions used in preparing these sensitivity analyses.

**PwC observation.** We would expect that disclosures prepared for directly held investments will be distinguished from those held in pooled funds, and that there may be differences in the extent of disclosure provided by the pooled funds, based on the availability of the underlying information.

The Frequently Asked Questions that accompany the Guidance Note address the situation where pooled funds may not have coterminous year-ends with your Plan.

If underlying audited financial statements for a pooled fund are not available, we expect disclosure of that fact will be made, and that the administrator will not be required to request unaudited information from the underlying investment manager to compile this information.

The extent of disclosures provided under the Guidance Note will vary depending on your Plan's circumstances and how you manage your Plan. While this newsletter discusses some of the requirements of the Guidance Note, it does not discuss all possible situations. Readers should refer to the requirements of the Guidance Note, its examples and to the Frequently Asked Questions that accompany the Guidance Note. Refer to the FSCO website at <http://www.fSCO.gov.on.ca/en/pensions/pensionbulletins/Pages/2014-march.aspx>

For more information about this publication or the adoption of the new FSCO expected disclosures for Ontario registered pension plans, please contact your local engagement leader or one of our Pension industry experts below:

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## Appendix – Example Disclosures for Pooled Funds Reporting

### Financial Instruments Risks

#### **PwC Assumptions:**

- This example is for a defined benefit pension plan
- This example assumes that the pension plan holds investments directly, as well as through pooled funds. If the Plan holds pooled funds only, the indirectly held portion of the tables only would be reported.
- Note that comparative information should be presented. For these examples, we have not provided comparative information.

The Plan's investments in financial instruments are susceptible to the following risks:

#### **1. Fair Value Measurement Risk**

The following is a breakdown of the Plan's directly held and indirectly held (through pooled funds) investments using the fair value hierarchy. The hierarchy assesses the subjectivity of inputs used in the fair value measurement in a three level classification:

- Level 1 – fair value based on quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – fair value based on inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (ie. as prices) or indirectly (ie. derived from prices); and
- Level 3 – fair value based on inputs for the asset or liability that are not based on observable market data (unobservable inputs).

	<b>As of December 31, 2013</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
	\$	\$	\$	\$
<b>Directly held investments</b>				
Canadian equities	5,305,000	-	-	5,305,000
Foreign equities	4,475,000	-	-	4,475,000
Fixed income	-	10,500,000	-	10,500,000
	<b>9,780,000</b>	<b>10,500,000</b>	<b>-</b>	<b>20,280,000</b>
<b>Indirectly held in pooled funds</b>				
Canadian equities	12,250,000	-	-	12,250,000
Foreign equities	7,250,000	-	-	7,250,000
Fixed income	-	15,000,000	-	15,000,000
	<b>19,500,000</b>	<b>15,000,000</b>	<b>-</b>	<b>34,500,000</b>
	<b>29,280,000</b>	<b>25,500,000</b>	<b>-</b>	<b>54,780,000</b>

The amounts shown as indirectly held in pooled funds represent the Plan's proportionate share of the fair value hierarchy of the investments held in the underlying pooled funds.

#### **2. Credit Risk**

The plan is subject to direct and indirect (through pooled funds) credit risk, which is the risk that a counterparty will be unable to pay amounts in full when they are due. The SIP&P restrictions prohibit directly or indirectly investing more than 5% of assets in any one entity, or two or more associated or affiliated entities. Furthermore, the SIP&P restricts investing more than 5% of assets in fixed income instruments with a credit rating below BBB.

The following are the Plan's interest-bearing financial instruments, the exposure to credit risk and the Plans' proportionate share of indirect credit risk.

	As of December 31, 2013		
	Directly Held	Indirectly Held in Pooled Funds	Total
	\$	\$	\$
AAA	2,500,000	3,000,000	5,500,000
AA	4,500,000	5,500,000	10,000,000
A	1,200,000	2,500,000	3,700,000
BBB	2,000,000	2,800,000	4,800,000
BB	300,000	400,000	700,000
Unrated	-	800,000	800,000
	<b>10,500,000</b>	<b>15,000,000</b>	<b>25,500,000</b>

### 3. Liquidity Risk

Liquidity risk is the risk the Plan may be unable to meet pension payment obligations in a timely manner and at a reasonable cost. Management of liquidity seeks to ensure that even under adverse conditions, the plan has access to immediate cash that is necessary to cover benefits payable, withdrawals and other liabilities. The SIP&P requires the plan's investments to be highly liquid, so they can be converted into cash on short notice. The plan has invested in highly liquid equities, and fixed income securities either directly or indirectly through its pooled funds, and therefore its exposure to liquidity risk is considered negligible.

The following is a maturity analysis of the Plan's investments that are held both directly and indirectly through its investment in pooled funds for managing liquidity risk.

Maturity	As of December 31, 2013					\$
	< 1 year	1 – 5 years	5 – 10 years	10 – 20 years	> 20 years	
	\$	\$	\$	\$	\$	
Directly held	2,500,000	1,000,000	1,000,000	2,500,000	3,500,000	10,500,000
Held in pooled funds	1,000,000	2,000,000	2,000,000	7,000,000	3,000,000	15,000,000
	<b>3,500,000</b>	<b>3,000,000</b>	<b>3,000,000</b>	<b>9,500,000</b>	<b>6,500,000</b>	<b>25,500,000</b>

The amounts shown as indirectly held in pooled funds represent the Plan's proportionate share of the investments held in the underlying pooled funds.

### 4. Market Risk

#### Currency risk

The Plan holds directly, and indirectly through its pooled funds, financial instruments denominated in currencies other the Canadian dollar - the measurement currency. The Plan is therefore exposed to currency risk as the value of these financial instruments will fluctuate due to changes in foreign exchange rates.

The following sensitivity analysis summarizes the impact on the Plan's net assets available for benefits, following changes of 5% in the Canadian dollar relative to other foreign currencies to which

the Plan has a significant exposure.

Currency	As of December 31, 2013			
	Directly Held	Indirectly Held	Total Exposure	Impact +/- 5%
	\$	\$	\$	\$
United States dollar	3,000,000	3,500,000	6,500,000	+/- 325,000
British pound	1,500,000	1,000,000	2,500,000	+/- 125,000
Euro	1,000,000	2,000,000	3,000,000	+/- 150,000
	<b>5,500,000</b>	<b>6,500,000</b>	<b>12,000,000</b>	<b>+/- 600,000</b>

The amounts shown as indirectly held represent the Plan's proportionate share of the foreign currencies held in underlying pooled funds.

### Interest rate risk

The Plan holds interest bearing financial instruments directly and indirectly through its investment in pooled funds. The Plan is therefore exposed to interest rate risk, as the value of interest-bearing financial instruments will fluctuate with the changes in interest rates. The following sensitivity analysis summarizes the decrease/increase in the Plan's net assets available for benefits following an increase/decrease in interest rates of 1% for all maturities, based on a parallel shift in the yield curve.

	Impact +/- 1%
	\$
Directly held	-/+ 100,000
Held in pooled funds	-/+ 120,000
	<b>-/+ 220,000</b>

### Equity price risk

The Plan holds equity financial instruments. The Plan is therefore exposed to equity price risk as the value of equity financial instruments will fluctuate due to changes in equity prices. The following sensitivity analysis summarizes the impact on the Plan's net assets available for benefits, following a general 10% change in equity prices.

	Impact +/- 10%
	\$
Directly held	+/- 978,000
Held in pooled funds	+/- 1,950,000
	<b>+/- 2,928,000</b>

## Methods and assumptions used in preparing sensitivity analysis

For indirect risk exposures from investments held in pooled funds, the various sensitivity analyses are based on similar disclosures presented in the audited financial statements of the various pooled funds. When the Plan invests in more than one pooled fund with similar financial instrument risks, the impact on the Plan's net assets available for benefits is calculated separately for each of these funds based on the pro rata holdings of the Plan, and then added together. When funds with similar financial instruments risk use a different level of reasonability of possible change to assess the impact on their net asset value, the impact has been estimated by pro rating the reported change in the audited financial statements in order to arrive at a consistent level of possible impact.

## Example of pro rating pooled fund risk disclosures

An example of how a Plan may aggregate its risk disclosures from underlying audited pooled fund financial statements, for *currency risk* is below:

Per audited financial statements	Total Currency Risk per Pooled Funds				Pro rated		
	Own %	United States dollar	British Pound	Euro	United States dollar	British Pound	Euro
		\$	\$	\$	\$	\$	\$
BMO U.S. equity fund	1.50%	66,667,000	-	-	1,000,000	-	-
PH&N U.S. bond fund	2.50%	80,000,000	-	-	2,000,000	-	-
PH&N Int' bond fund	4.00%	12,500,000	25,000,000	50,000,000	500,000	1,000,000	2,000,000
		<b>3,500,000</b>			<b>1,000,000</b>		<b>2,000,000</b>

*Financial statement risk disclosure*