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How the Credit Crunch Affects an Employer's Accounting for and Disclosure of its Defined Benefit Pension Plans

In this memorandum, we discuss the impact of the credit crunch on an employer's accounting for and disclosure of its defined benefit pension plans under Canadian GAAP. A defined benefit plan is one where an employee receives fixed or determinable pension benefits from the employer. As such the employer retains the investment and actuarial risks associated with the plan.

Basic principles

The principles for recognizing and measuring pension expense are set out in CICA Handbook Section 3461, Employee Future Benefits (the "Section"). Broadly speaking, an employer determines its pension expense for a year using actuarial assumptions it establishes as at the beginning of the year. The employer also uses these assumptions to project what the value of the plan's assets and its obligation to employees and retirees will be at the end of the year (the Section refers to this obligation as the "accrued benefit obligation" or "ABO"). Any differences between these beginning of the year estimates and the actual fair value of plan assets and the ABO at the end of the year represent "actuarial gains" or "actuarial losses". While it is possible to recognize actuarial gains and losses immediately in net income, employers usually amortize these over extended periods, often the remaining average service life of employees. Under the so-called "corridor approach", amortization does not begin unless the cumulative net actuarial gain or loss exceeds specified threshold amounts at the beginning of the year.

As a matter of accounting policy, entities can elect to measure plan assets and the ABO at a date within three months of their year end. For example, a company with a calendar year end can measure plan assets and the ABO at September 30 instead of at December 31. In this

case, pension expense for the year ended December 31, 2008 would be determined using assumptions established at September 30, 2007 that cover the following 12 months. For ease of discussion, we refer to valuations of plan assets and the ABO as being at the "end of the year".

As we shall see, the credit crunch does not alter the way an employer applies these basic principles but it can have a material effect on future years' pension expense and contributions and current year disclosures.

Interim remeasurements

When a significant event occurs, such as a plan amendment, settlement or curtailment, the Section generally requires the employer to remeasure plan assets and the ABO as at the date the event occurs, using updated assumptions. When this happens, the entity measures pension expense for the remainder of the year using these new assumptions.

Is the credit crunch an event that requires an interim remeasurement in 2008? While the credit crunch certainly has been significant, we don't believe it's the type of event that would require an employer to carry out

an interim remeasurement. In our view, the guidance in the Section relating to interim remeasurements applies to events that are plan specific.

If an employer voluntarily remeasures plan assets and obligations at an interim date, for whatever reason, the employer should use it to calculate pension expense for the remainder of the year.¹

2008 actuarial loss on plan assets

Under Section 3461, plan assets are required to be measured at fair value at the measurement date. Because of significant declines in the market values of assets during 2008, it has become apparent that many pension plans likely will report significant actuarial losses on the revaluation of plan assets at the end of the year. Indeed, it appears that in many cases the actual return on assets, measured on a fair value basis, will be negative. As explained earlier, these actuarial losses usually will not affect pension expense in 2008 but will be recognized in later years, depending on the employer's amortization policy for actuarial gains and losses.

A significant decline in the value of plan assets at the year end may turn what was a surplus at the beginning of the year into a deficit. An employer would treat such a decline in the normal fashion (i.e. as contributing to the actuarial loss on plan assets). There is one possible twist. An employer might have established a valuation allowance in a prior year that limited the pension asset the employer recognized in its balance sheet for the surplus (recognition of a valuation allowance is required

under Section 3461 if there are restrictions on the employer's ability to realize the surplus). If the surplus has disappeared by the end of 2008, the employer should reverse the valuation allowance by crediting net income in 2008. While this is counter-intuitive to many, the requirements of the Handbook are very clear.

The extent of actuarial losses on plan assets in 2008 is a factor that employers should consider in estimating the expected return on long-term assets that will be used in calculating pension expense for 2009.

2008 actuarial gain or loss on ABO

Conceptually, the ABO represents the present value of pension benefits that have been earned to date and are expected to be paid to retirees. Under Section 3461, the rate used to discount the cost of providing these benefits usually is based on interest rates on high quality corporate bonds prevailing at the measurement date. Credit spreads on corporate bonds have widened during 2008 even though risk free rates have declined. It therefore is possible that the discount rate used in measuring the ABO at year end will be higher than the rate used at the beginning of the year. Other things being equal, using a higher discount rate would produce a lower ABO and an actuarial gain that will offset somewhat the actuarial loss incurred on plan assets.

Deciding what discount rate to use to value the ABO at the end of 2008 may be a significant issue. Given the potential impact of the credit crunch on issuers of bonds, employers may wish to consider whether it is necessary to modify approaches used in prior years to make this

¹ A Canadian employer may have established an accounting policy for valuing plan assets and the ABO at a date earlier than its year end for Canadian GAAP purposes but value plan assets and the ABO at its year end in order to provide the US GAAP information required under FAS 158, Employer's Accounting for Defined Benefit Plans and Other Postretirement Plans. If so, the employer should use the later valuation for Canadian GAAP purposes.

determination. In general, the objective of selecting a discount rate is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary pre-tax cash flows to pay the accrued benefits when due.

Pension expense for any year includes the interest cost on the ABO. The discount rate at the end of 2008 will be used to determine the interest cost on the ABO in the calculation of the 2009 pension expense.

Extrapolations

The ABO is determined from actuarial valuations performed periodically. In years between valuations, an extrapolation of the actuarial valuation is used. The Section states that management reviews matters such as changes to the plan, the actuarial assumptions, occurrence of settlements and curtailments, changes to the employee group and the rate of return on plan assets, and determines whether such matters necessitate any adjustments to an extrapolation. Section 3461 further states that when the effect of any change is significant, a new valuation may be necessary. Accordingly, management in consultation with its actuaries should be considering whether events in the year, including the credit crunch, preclude the use of an extrapolation.

Employer contributions

Employer contributions to pension plans are not determined by GAAP but rather by federal or provincial regulation. As a general rule, existing regulations require

the funded status of the plans to be estimated periodically on a "solvency" (i.e. wind up) basis. Employers usually are required to fund significant asset shortfalls over a five year period.

It has been widely reported in the press that regulators are considering amending the regulations to extend the period for funding plan deficits, but no changes have been made to date. As discussed further below, employers should be considering funding obligations in their disclosures and, of course, in going concern assessments.

Curtailments and settlements

In response to the credit crunch, an employer might significantly reduce employee levels. These actions can result in a curtailment to the pension plan with income statement consequences. Pension plan settlements also are possible (e.g. an employer eliminates its obligation to pay retirement benefits by purchasing annuities for employees).

Curtailments can affect income as the result of an ABO remeasurement or the expensing of past service costs. Settlements generally trigger the recognition in income of all or a portion of unamortized actuarial gains or losses and certain other unrecognized amounts in a plan (e.g. the unamortized transitional obligation).

Curtailment losses are recognized when it is probable that the curtailment will occur and the effects are reasonably estimable. Curtailment gains are recognized when the curtailment occurs. Settlement gains and losses are recognized only when the settlement occurs.

Balance sheet presentation

The carrying value of a pension plan under Canadian GAAP is solely the product of the accounting entries made to recognize pension expense for the year and contributions to or from the plan. Because past service costs, actuarial gains and losses and other items typically are not recognized under Section 3461 in the year in which they arise, the pension asset or liability the employer recognizes in its balance sheet usually will not reflect the funded status of the plan. However, an employer is required to reconcile the funded status of the plan to the amount recognized on the balance sheet as part of its pension disclosures.

Financial statement disclosure

Beware. The specific disclosure requirements in Section 3461 are minimum disclosures only. The over-riding requirement is to provide useful information about the costs, risks and uncertainties of the entity's defined benefit plans, their impact on the financial statements, and the underlying plan assets and obligations. Overall, the objective is to provide information that allows financial statement users to make resource allocation decisions and assess management stewardship.

The Section requires extensive disclosures about an employer's defined benefit plans including disclosures about (a) accounting policies used; (b) how the plans affect the employer's financial statements; (c) particulars about plan assets and liabilities; (d) significant assumptions used in accounting; and (e) details of settlements and curtailments. Some relief is provided for entities that are not publically accountable in 3461.159.

The Section does not expressly require disclosure of future funding obligations but an entity might consider that disclosure is appropriate in some circumstances under other standards (see below) or upon consideration of the overall disclosure objective in Section 3461.

There is no requirement in Section 3461 for an employer to provide sensitivity analysis that shows how net income would have been affected by changes in risk variables affecting the employer's pension accounting that were reasonably possible at the balance sheet date. While Section 3862 requires entities to provide this information for financial instruments, employer's rights and obligations under pension plans do not fall within the scope of this standard.

Other Handbook Sections may be relevant in assessing the appropriateness of pension disclosures. These include Section 1508, Measurement Uncertainty, Section 3280, Contractual Obligations, and Section 1400, General Standards of Financial Statement Presentation. The appropriate disclosure that is necessary for a particular plan is a matter of judgment that will depend on the particular facts and circumstances.

Section 1508

Section 1508 requires an entity to disclose the nature of any measurement uncertainty that is material and, if it is reasonably possible that the recognized amount could change by a material amount within one year, its extent. A measurement uncertainty exists when there is uncertainty over the recognized amount and another reasonably possible amount. As explained earlier, the amount of pension expense recognized for a year is a function of assumptions that are uncertain by nature. A

measurement uncertainty relating to the determination of pension expense therefore would appear to exist. Whether this uncertainty is material to the financial statements as a whole, and whether it is reasonably possible that the actual experience of the plan could trigger a change in the amount recognized in the financial statements for pensions that is material will depend on the circumstances of the plan and other factors such as the entity's policy for amortizing actuarial gains and losses.

Section 3280

Section 3280 requires an entity to disclose the particulars of any contractual obligations that are significant in relation to the current financial position or future operations. Pension funding obligations usually are contractual in nature.

Section 1400

Section 1400 states that fair presentation in accordance with GAAP is achieved by (a) applying Section 1100, Generally Accepted Accounting Principles; (b) providing sufficient information about transactions or events having an effect on the entity's financial position, results of operations and cash flows for the periods presented that are of such size, nature and incidence that their disclosure is necessary to understand that effect; and (c) providing information that is clear and understandable. Section 1400 also requires an entity to assess its ability to continue as a going concern and disclose significant uncertainties that cast significant doubt upon the entity's ability to continue as a going concern.

MDA disclosure

Public companies are required to provide an analysis of trends or expected fluctuations in liquidity, taking into account demands, commitments, events or uncertainties, as well as an analysis of critical accounting estimates. In recent comment letters, Canadian securities regulators have requested companies to confirm that, if material, a company's MDA disclosure will include:

- A discussion of the anticipated impact of the funded status of a company's defined benefit plans on future contributions, cash flow and future pension expense.
- Total pension contribution obligations in the contractual obligations table.
- A company specific discussion on the risks associated with their pension plan, e.g. that there is no assurance that the plan will be able to earn the assumed rate of return; market driven changes may result in changes to the discount rates or other variables which would result in the employer being required to make contributions in the future that differ significantly from estimates; and the measurement uncertainty incorporated into the actuarial valuation process.
- A discussion of critical accounting estimates pertaining to the pension plan.

Other defined benefit plans

The foregoing discussion may be relevant in assessing the company's other defined benefit plans. In all cases reference should be made to the applicable requirements of the Handbook.