



# Analysis

May 2004

## Call to account

*New disclosures for plan sponsors are just around the corner*

*Who, exactly, is affected and how onerous are the new rules? The answer depends in part on the type of benefit plan you have and whether or not yours is a publicly-traded company.*

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If your company sponsors an employee retirement arrangement or post-employment benefit plan, you'll soon be adding some new pages to your financial statement. Not that this should come as a surprise. The Canadian Institute of Chartered Accountants (CICA) released a preliminary draft of its new disclosure rules back in October 2003 with the hope of implementing them by year-end. However, stakeholder feedback pushed the final release of the new standards to March 2004, when they were published in the annual update to the CICA Handbook, Section 3461.

Sponsors of defined benefit pension plans and post-employment or post-retirement plans (such as health care benefits, sick leave plans, long-term retirement gratuities, etc.), must comply with the new rules in their next year-end financial statements. Additional disclosures (see over) apply for life insurance companies, co-operative organizations, deposit-taking institutions and companies traded on a stock exchange. Multi-employer plans that account for their plans on a defined contribution basis are exempt from the new disclosures.

### **Pension "expense" eliminated... in name, at least.**

In keeping with the terminology adopted by the U.S. Financial Accounting Standards Board (FASB), the pension expense reported on the income statement has now been replaced by the pension cost.

## What's new

New areas of disclosure include significant accounting policies, a plan description, measurement and valuation dates, a breakdown of assets by category, and more details on assumptions.

### *Significant accounting policies*

The following information must now be included:

- ① If benefits are affected by salary level or cost escalation increases and whether a projected actuarial valuation method has been used.
- ② If asset smoothing has been used to calculate the expected return on plan assets and the smoothing method used for each asset class.
- ③ How past service costs and any transitional assets/obligations have been amortized and their amortization period.
- ④ How actuarial gains and losses have been amortized, and their amortization period.
- ⑤ The sequence used when a settlement and curtailment arise in the same event.
- ⑥ For multi-employer plans, a statement on whether or not defined contribution accounting is being used.



## Interim statements

*Quarterly financial statements must report both the total benefit cost for the quarter and the fiscal year-to-date.*

*(continued from front)*

### **Plan description**

The financial statement must now include a description that identifies:

- ① whether the pension plan is a flat-benefit or final-pay plan as well as any indexing features.
- ② any other benefits that are included, such as life insurance, health care, dental care, etc.

### **Measurement and valuation dates**

To give analysts an idea of when cash flow may change due to a new funding valuation that may impose additional contributions, plan sponsors must now include dates of the most recent and next required funding valuations.

The exposure draft's requirement to disclose expected minimum

*(continued on page 3)*

## Three more disclosures for public entity disclosures

In addition to the new disclosures listed above, public entities have three further disclosures.

### **① Components of cost**

Public companies are now required to show in a single place all events that impact the pension or benefit cost during the year.

These include:

- current service cost,
- interest cost,
- actual return on plan assets,
- full amount of benefit increases, and
- total actuarial gains or losses.

These amounts must be subtotaled, with the effects of smoothing and deferral reported separately, to show how the final pension or benefit cost recorded on the income statement is reached (see sample disclosure note). By requiring costs to be disclosed without smoothing and deferral, the CICA has gone beyond U.S. GAAP standards, but is consistent with disclosures under the U.K. accounting standard, FRS 17. This may well

foreshadow things to come, given that the CICA is expected to deliberate about whether smoothing and deferral should continue to be used when determining the annual cost of employee future benefits.

### **② Reconciliation of off-balance sheet amounts**

Public companies must reconcile between the total benefit obligation and the total benefit asset/liability. The difference between the two numbers is any unamortized balances, such as unamortized actuarial gains and losses, that are held *off the balance sheet* until they are brought into the income statement through annual amortization.

### **③ Sensitivity analysis**

In keeping with FAS 132, public companies must also show the sensitivity of post-retirement benefits to a 1% increase and decrease in health care trend rates.

## New U.S. disclosures

*(continued from page 2)*

pension contributions and expected additional contributions to be made by the sponsor in the current and next fiscal year has, fortunately, been dropped. Instead, the CICA has opted to require sponsors to report the more straight-forward total cash payments made during the fiscal year for their plans, including benefits paid in unfunded plans.

Sponsors must also include the date used to measure assets and liabilities as shown in the financial statements.

### **Asset breakdown**

At a minimum, the market value of assets must now be broken down into three asset classes: equities, fixed income and real estate. Although it would have made the methodology for choosing expected rates of return much more transparent, the CICA decided not to proceed with the exposure draft suggestion of providing expected returns for each asset class. Nevertheless, plan sponsors should be prepared to defend their assumptions, as analysts begin to scrutinize projected rates of return more closely.

### **Other disclosures**

Additional minor disclosure items required on all financial statements are:

- ① explicitly identifying assumptions used to calculate both the pension or benefit cost for the fiscal year and the year-end benefit obligation, and
- ② telling users where to find the total benefit asset or liability on the balance sheet.

Unlike its Canadian counterpart, the U.S. Financial Accounting Standards Board (FASB) was unwilling to back off on its aggressive timeline, releasing its revised Statement 132 in the third week of December 2003 with an effective date of December 15, 2003 (June 15, 2004 for non-public entities and foreign plans such as Canadian plans).

Some Financial Accounting Standards (FAS 132) disclosures are identical to CICA disclosures as follows:

- ① Disclosing the measurement date of the financial statement's assets and liabilities.
- ② Breaking down the market value of assets by asset category.
- ③ Explicitly identifying the assumptions used to calculate both the pension and benefit cost for the fiscal year and the year-end accrued benefit obligation.

While the FASB did not consider showing the effects of smoothing and deferral on the pension or benefit cost, it did include some unique new disclosures of its own.

### **Narratives**

FAS 132 requires two new narratives. The first is a narrative description of the plan's investment policy, including any target asset allocation percentages. Other factors that help to explain the investment policy, such as risk management practices, permitted and prohibited investments, and the relationship between assets and liabilities (such as immunization) must also be discussed.

The second narrative must describe the basis for the development of the expected rate of return on assets. This includes the extent to which historical

information is used, what adjustments have been made to the historical information to reflect the expectation of future returns, and how adjustments were determined.

### **Expected contributions for next fiscal year**

Whereas the CICA dropped this disclosure from its exposure draft, the FASB kept its required guesstimate of the expected contributions to be made in the next fiscal year. Minimum contributions from an actuarial valuation, additional discretionary contributions, and benefit payments to unfunded plans must all be included.

### **Expected benefit payments**

The most onerous new U.S. requirement, from a calculation standpoint, is the reporting of the expected benefit payments for the next 10 years. Each of the first five year's expected benefit payments must be listed separately, with the second five years presented as an aggregate number.

The calculation of the expected benefit payments is based on the same data used in the calculation of the benefit obligations, assuming no new hires. Expected changes in benefits due to salary increases, additional service rendered, or any other factor must also be included.

### **Accumulated benefit obligation**

For pension plans only, the financial statements must disclose the accumulated benefit obligation. This measure, not calculated in Canada, does not incorporate salary increases and is used to determine another U.S.-only measure, the additional minimum liability.

## Public Company Disclosure as of December 31, 2003

### Note 1: Significant accounting policies (additional content)

The projected benefit method prorated on service is used to determine the accrued benefit obligation because pension and other post-retirement benefits are affected by salary increases and health care trend increases.

The expected return on assets is based on the fair value of assets for the pension plans.

The excess of unamortized actuarial gains or losses over 10% of the greater of the fair value of plan assets and the benefit obligation is amortized over the average remaining service period of active employees. The average remaining service period for the pension plans is 13 years in 2003 (13 in 2002) and the average remaining service period for the other benefit plans is 11 years in 2003 (11 years in 2002).

Any past service costs arising from plan amendments are amortized over the average remaining service life of active employees as of the effective date of the amendment, on a straight-line basis.

When an event gives rise to both a curtailment and a settlement of the accrued obligations, the curtailment is accounted for before the settlement.

On January 1, 2000, the Company adopted the new accounting standard CICA Section 3461 on a retroactive basis. The Company charged to retained earnings the difference between the accrued benefit liability held on the balance sheet under the old standard and the accrued benefit liability as of January 1, 2000 under Section 3461.

### Note 2: Pension and other post-retirement benefit plans (all amounts are in thousands of dollars)

#### Description of plans (this section is new)

The Company sponsors two funded defined benefit pension plans and provides other post-retirement benefits to all its staff. The defined benefit pension plan for hourly employees is a flat-dollar plan with negotiated increases and the defined benefit plan for salaried employees is based on an employee's final average earnings. Neither plan provides indexation in retirement. The other post-retirement benefits provided include health care, dental care and life insurance coverage on a non-contributory basis.

#### Total cash payments (this section is new)

The total cash payments during 2003 by the Company was \$1,050 (\$600 in 2002). The cash payments consisted of contributions required to fund the pension plans and premiums paid to an insurance company for the other post-retirement benefit plans.

#### Measurement date (this section is new)

The company measures the fair value of assets and the accrued benefit obligations as of December 31. The most recent actuarial valuations on both pension plans was as of December 31, 2002. Funding valuations are currently being completed as of December 31, 2003 for both pension plans.

#### Reconciliation of the accrued benefit obligations

	Pension Plans		Other Benefit Plans	
	2003	2002	2003	2002
Balance at January 1	\$ 4,998	\$ 4,200	\$ 1,391	\$ 1,150
Current service cost	500	450	300	250
Interest cost	322	291	94	76
Benefits paid	(600)	(550)	(200)	(200)
Actuarial (gains)/losses	183	307	71	115
Plan amendments		300		
Settlements				
Curtailments				
Balance at December 31	\$ 5,403	\$ 4,998	\$ 1,656	\$ 1,391

#### Reconciliation of the fair value of assets

	Pension Plans		Other Benefit Plans	
	2003	2002	2003	2002
Balance at January 1	\$ 3,654	\$ 4,000	\$ 0	\$ 0
Actual return on plan assets	491	(196)		
Employer contributions	850	400		
Employee contributions	0	0		
Benefits paid	(600)	(550)		
Settlements				
Curtailments				
Balance at December 31	\$ 4,395	\$ 3,654	\$ 0	\$ 0

#### Plan assets consist of: (this section is new)

	Percentage of Plan Assets	
	2003	2002
Equities	57%	60%
Fixed income	32%	30%
Real estate	0%	0%
Other	11%	10%
Total	100%	100%

#### Reconciliation of funded status to the amounts recorded in the financial statements (this section is new)

	Pension Plans		Other Benefit Plans	
	2003	2002	2003	2002
Fair value of plan assets	\$ 4,395	\$ 3,654	\$ 0	\$ 0
Accrued benefit obligation	5,403	4,998	1,656	1,391
Surplus/(deficit)	(1,008)	(1,344)	(1,656)	(1,391)
Unamortized net actuarial loss	45	70	91	20
Unamortized past service costs	270	300	0	0
Unamortized transitional asset	0	0	0	0
Accrued benefit asset/(liability)	\$ (693)	\$ (974)	\$ (1,565)	\$ (1,371)

The accrued benefit liabilities for the pension and other benefit plans are reported in the Company's balance sheet under Other Liabilities. (this disclosure is new)

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# Sample disclosure note

(continued from page 4)

## Public Company Disclosure as of December 31, 2003

### Components of net benefit costs recognized during the year (this section is new)

	Pension Plans		Other Benefit Plans	
	2003	2002	2003	2002
Current service cost	\$ 500	\$ 450	\$ 300	\$ 250
Interest cost	322	291	94	76
Actual return on plan assets	(491)	196	0	0
Actuarial (gains) losses	183	307	71	115
Plan amendments	0	300	0	0
Curtailment gain				
Settlement gain				
<b>Elements of employee future benefit costs before adjustments to recognize the long-term nature of employee future benefit costs</b>	<b>514</b>	<b>1,544</b>	<b>465</b>	<b>441</b>
<b>Adjustments to recognize the long-term nature of employee future benefit costs:</b>				
Difference between expected return and actual return on plan asset for year	208	(490)	0	0
Difference between actuarial loss recognized for year and actual actuarial loss on accrued benefit obligation for year	(183)	(307)	(71)	(115)
Difference between amortization of past service cost for year and actual plan amendment cost for year	30	(300)	0	0
Amortization of transitional obligation	0	0	0	0
Subtotal	55	(1,097)	(71)	(115)
<b>Defined benefit cost recognized</b>	<b>\$ 569</b>	<b>\$ 447</b>	<b>\$ 394</b>	<b>\$ 326</b>

### Key assumptions (parts of this section are new)

	Pension Plans		Other Benefit Plans	
	2003	2002	2003	2002
Accrued benefit obligation as of December 31:				
Discount rate	6.25%	6.50%	6.25%	6.50%
Salary increases	3.50%	3.50%		
Benefit cost for year ended December 31:				
Discount rate	6.50%	7.00%	6.50%	7.00%
Expected rate of return on assets	7.50%	7.50%		
Salary increases	3.50%	3.50%		
Health care trend rates at December 31:				
Initial rate			10%	10%
Ultimate rate			5%	5%
Year ultimate rate reached			2009	2008

### Sensitivity analysis (this section is new)

A one-percentage point change in the assumed health care trend rates would have the following effects for 2003:

	Increase	Decrease
Total of service cost and interest cost	\$ 31	\$ (29)
Accrued benefit obligation	280	(262)

## Excerpt from U.S. Public Company Disclosure as of December 31, 2003

### Cash Flows

### Contributions

The Company expects to contribute \$900,000 to its pension plan and pay premiums of \$200,000 in respect of its post-retirement benefit plan in 2004.

### Estimated Future Benefit payments

The following benefit payments, which reflect expected future service where appropriate, are expected to be paid: (in thousands of dollars)

	Pension Benefits	Other Benefits
2004	\$ 650	\$ 200
2005	670	204
2006	690	208
2007	711	212
2008	732	216
2009-2013	3,941	1,135



## Time will tell

The CICA's stated purpose in releasing its new standards was to provide more information and transparency to analysts and stakeholders in this time of trying equity markets, company failures and increased scrutiny of accounting practices. Whether the new rules will accomplish the CICA's goals remains to be seen.



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