Employee Future Benefits, Section 3462 – Background Information and Basis for Conclusions

November 2020

TABLE OF CONTENTS

INTRODUCTION

1 This document summarizes considerations that were deemed significant by the members of the Accounting Standards Board (AcSB) in reaching their conclusions in amending EMPLOYEE FUTURE BENEFITS, Section 3462. This document sets out the reasons the Board undertook the project to develop the amendments, the process of research and deliberation, the key decisions made, and the principal reasons for adopting the positions taken and rejecting others. Individual Board members gave some factors greater weight than other ones.

2 Nothing in this document is to be taken as overriding the requirements of Part II of the Handbook. However, the discussion may help readers understand how the AcSB reached its conclusions in developing the amendments and the Board's intent with respect to interpretation and application of the amendments.

BACKGROUND

3 Stakeholders have informed the AcSB about diversity arising in practice from enterprises applying Section 3462 in Part II of the Handbook, regarding the use of the actuarial valuation for funding purposes (funding valuation) in the measurement of the defined benefit obligation (DBO). This diversity relates to how this Section's requirements interact with recent changes to pension legislation, including changes in Ontario and Quebec.

4 In July 2016, pension regulations in Quebec introduced a Stabilization Provision (SP). The Quebec regulations require this provision to be funded for private sector defined benefit pension plans on a going concern basis effective from January 1, 2016. In April 2018, the pension regulations in Ontario introduced new funding rules for defined benefit single employer pension plans. The amended Ontario regulations govern the establishment and funding of a new reserve in the going concern valuation for a pension plan called the Provision for Adverse Deviation (PfAD). The funding rules outlined within the Ontario regulation apply to actuarial valuations with valuation dates of December 31, 2017, or later and filed after April 30, 2018.

5 As a result of these regulatory changes, stakeholders raised an issue with the AcSB regarding the measurement of the DBO when the funding valuation option is chosen in Section 3462. Specifically, stakeholders are unclear on whether the SP and PfAD should be included in the measurement of the DBO, which results in diversity in practice.

6 In response to this stakeholder feedback, the AcSB decided to amend Section 3462 to clarify the measurement of the DBO when a funding valuation is used. The objective of the amendments is to eliminate the diversity in practice regarding measurement of the DBO. As such, the amendments seek to clarify the measurement of the DBO for plans in which there is a legislative, regulatory or contractual requirement to prepare a funding valuation.

7 When the AcSB set out to clarify the measurement of the DBO for plans in which there is a legislative, regulatory or contractual requirement to prepare a funding valuation, the Board considered how the accommodation to use a funding valuation for defined benefit plans without a funding valuation could be applied, given the requirement to prepare the valuation on a "basis consistent with". The Board was concerned about the ability to include all legislative, regulatory and contractual components in a plan that does not require a funding valuation, the complexity associated with applying the accommodation and that it would create further diversity in practice.

APPLICABILITY

8 Stakeholders may apply Section 3462 either:

(a) directly as a private enterprise that applies Part II of the Handbook;

(b) via REPORTING EMPLOYEE FUTURE BENEFITS BY NOT-FOR-PROFIT ORGANIZATIONS, Section 3463 in Part III of the Handbook; or

(c) via PENSION PLANS, Section 4600 in Part IV of the Handbook.

9 Section 3463 in Part III of the Handbook prescribes the accounting treatment for employee future benefits provided by a not-for-profit organization (NFPO). Except as otherwise provided for in Section 3463, a NFPO applies Section 3462. Therefore, NFPOs with defined benefit plans would be required to follow these amendments. Accordingly, while developing the amendments, the AcSB updated its Not-for-Profit Advisory Committee on the project and provided the Advisory Committee members with opportunities to highlight any unique considerations for NFPOs applying these amendments.

EFFECTS ANALYSIS

10 The AcSB acknowledges that the amendments may result in a change in practice for some enterprises.

11 Based on feedback from its Private Enterprise Advisory Committee (Committee) and actuaries, the AcSB expects the following costs associated with the amendments:

(a) incurring the costs associated with an actuarial valuation for accounting purposes (accounting valuation) for any defined benefit plans without a funding valuation requirement, including determining actuarial assumptions based on management's best estimate and the discount rate; and

(b) communication with financial statement users about the effect of the changes to Section 3462.

12 The AcSB sought to minimize the costs associated with the amendments by proposing transition relief. For example, the Board decided that an enterprise would not be required to:

(a) obtain a new funding valuation on transition; and

(b) retroactively restate its financial statements for the effects of the amendments.

13 The AcSB expects financial statement users will benefit from an increased understanding of employee benefit costs in the financial statements of enterprises applying Section 3462 as follows:

(a) consistency in accounting for defined benefit plans with a funding valuation requirement by clarifying the amounts required to be included in measuring the DBO when an enterprise elects to use the funding valuation accommodation; and

(b) improved comparability between enterprises as defined benefit plans without a funding requirement would be required to use an accounting valuation to measure the DBO for these plans.

DEVELOPMENT OF THE STANDARD

14 Throughout the development of the amendments to Section 3462, the AcSB followed its due process. The process included:

(a) Issuance in September 2019 of the Exposure Draft;

(b) Analysis and consideration of feedback received through written responses to the Exposure Draft (26 comment letters);

(c) Ongoing input from the Committee;

(d) Follow-up discussions with respondents and the Committee to obtain additional feedback;

(e) Consultations on the Exposure Draft proposals with 10 stakeholders at a roundtable event;

(f) Consultations with a stakeholder group of actuaries; and

(g) Consultations with subject matter experts, as applicable.

15 The AcSB also asked Committee members to perform a fatal-flaw review of the final amendments to the standard to ensure the guidance is:

(a) Clear in reflecting the Board's intent; and

(b) Written in a manner that is consistent with other guidance in Part II of the Handbook.

16 In developing the amendments to Section 3462, the AcSB considered the consequences of adopting new guidance relative to the objective of financial statements and benefit versus cost constraint. As described in FINANCIAL STATEMENT CONCEPTS, paragraph 1000.12, the purpose of financial reporting is to "communicate information that is useful to investors, creditors and other users in making their resource allocation decisions and/or assessing management stewardship." Also, as described in paragraph 1000.13, the Board considered the benefit versus cost constraint which states: "in developing accounting standards, the Board weighs the anticipated costs and benefits of its proposals in general terms to assess whether they are justified on cost/benefit grounds."

17 The AcSB received 26 written responses to the Exposure Draft from preparers, actuaries, regulators, users and public accounting firms. The Board reminds stakeholders that as part of its due process related to Part II of the Handbook, it makes available a public file of materials relating to completed projects, which includes response letters received unless confidentiality is requested.

18 Respondents, including participants at meetings, supported the underlying principles in the Exposure Draft. However, some respondents provided additional comments suggesting changes to some of the proposals.

19 The specific issues addressed in this project, including the substantive comments received on the Exposure Draft and any changes made in response to those comments, are as follows.

MEASUREMENT OF THE DEFINED BENEFIT OBLIGATION

Amount required to be funded by contributions

20 Section 3462 permits enterprises with defined benefit plans that have a funding valuation requirement an accounting policy choice to measure the DBO using a funding valuation or an accounting valuation. The AcSB continues to support this choice in the amendments. However, the Board emphasizes that the accounting valuation remains the best estimate in measuring the DBO for financial statement purposes.

21 A funding valuation and an accounting valuation have different objectives and may use actuarial assumptions that are not the same, resulting in obligations and cost numbers that differ. Funding valuations are prepared in accordance with legislative, regulatory or contractual requirements, generally to determine required contributions to the plan.

22 The AcSB sought to clarify the guidance regarding measurement of the DBO to ensure that it remained relevant to current and future legislation. In developing the amendments, the Board considered the following:

(a) The use of a funding valuation was an accommodation that eliminated the additional costs of preparing an accounting valuation. The funding valuation is not management's best estimate; an accounting valuation is management's best estimate; and

(b) The standard describes a funding valuation as being prepared in accordance with legislative, regulatory or contractual requirements. It is the amount at which the legislation, regulation or contract would require funding by contributions.

23 The amendments clarify that when legislative, regulatory or contractual requirements stipulate calculations of various components of the funding requirement separately, the aggregate of those components makes up the funding valuation that would be reflected in the financial statements. Accordingly, the measurement of the DBO in the financial statements reflects the aggregate of the components of the funding valuation. For example, the Ontario pension regulator's PfAD and the Quebec pension regulator's SP are components of an Ontario and a Quebec funding valuation, respectively, and, accordingly, would be included in the measurement of the respective DBO. The Board understands that both the PfAD and the SP conceptually represent reserves for poor experience. However, the Board notes that these amounts, albeit reserves for poor experience, are required to be funded by contributions to the plan and, therefore, represent outflows that a plan sponsor is obligated to make.

24 The AcSB received feedback asking for clarification on the definition of the "aggregate of all underlying components", as described in paragraph 3462.029AC. The Board decided to add an illustrative example to Section 3462 to help clarify the definition.

25 The AcSB acknowledges that contributions may be funded by means other than cash. Paragraph 3462.029AB has been amended to remove the specific reference to cash. In addition, to illustrate the types of contributions that may be included, examples of non-cash contributions have been included in paragraph 3462.029AC.

Types of funding valuations

26 When electing to use a funding valuation, the AcSB proposed removing from paragraph 3462.029D the term "solvency" from among the excluded types of funding valuations that may be used. The Board was concerned that stakeholders may exclude Quebec's SP from measurement of the DBO, as the Board understands that some stakeholders may view the SP as being akin to a solvency valuation.

27 The AcSB received feedback from several stakeholders emphasizing the importance of including the term "solvency" in paragraph 3462.029D, as it serves to specifically exclude valuations prepared using a plan termination scenario. As a result of the feedback received, the Board decided to retain the term "solvency" among the excluded types of funding valuations. The Board received feedback indicating that it was sufficiently clear that the SP should be included in the measurement of the DBO, without the need to remove the term "solvency".

28 The AcSB confirmed its intent to avoid a specific reference to the going concern funding valuation to allow entities with individual pension plans accounted for as defined benefit plans to use the funding valuation referred to in the Income Tax Act.

29 The AcSB received feedback from a stakeholder suggesting more guidance be provided on the measurement of the DBO for individual pension plans. The Board discussed the feedback and decided that it was out of scope for this project. The Board will consider a future project on individual pension plans.

Accommodation to use a funding valuation for defined benefit plans without a funding valuation requirement

30 Prior to the amendments, Section 3462 permitted an accounting policy choice to measure defined benefit plans without a funding valuation requirement using an accounting valuation or a funding valuation for when certain conditions were met. For a DBO with no legislative, regulatory or contractual requirement to prepare an actuarial valuation for funding purposes, Section 3462 required the funding valuation to be an actuarial valuation prepared "on a basis consistent with" that used for those plans for which a funding valuation is required to be prepared to comply with legislative, regulatory or contractual requirements.

31 The AcSB consulted with actuaries from public accounting and actuarial firms. During its consultations, the Board heard that the accommodation to allow the use of a funding valuation for defined benefit plans without a funding valuation requirement when certain conditions were met caused diversity in practice. The Board understands that this accommodation created challenges and complexities in applying the requirement "on a basis consistent with". For example, the determination of actuarial assumptions and the discount rate associated with defined benefit plans with and without a funding valuation requirement provided to different employee and retiree groups is complex.

32 Accordingly, the AcSB reconsidered the accounting policy choice to measure the DBO using a funding valuation or an accounting valuation for defined benefit plans without a funding valuation requirement when certain conditions have been met. Actuaries told the Board about diversity arising in practice from:

(a) difficulties in understanding how to determine an amount that is required to be funded by contributions such as the PfAD on a plan without any plan assets; and

(b) the adjustments made or not made between defined benefit plans with and without a funding valuation requirement, such as with mortality assumptions.

33 The AcSB understands that including a PfAD or an SP component in the measurement of the DBO for defined benefit plans without a funding valuation requirement when certain conditions have been met can create challenges, such as:

(a) for mature plans whereby the release of liabilities from either of these components can result in a remeasurement gain on the DBO resulting in pension income, rather than pension expense; and

(b) applying either of these components from a small defined benefit plan with a funding requirement for executives to a much larger defined benefit plan without a funding valuation requirement for all employees can have a significant effect on the plan sponsor's financial statements.

34 Given this diversity, the AcSB decided to remove this accommodation.

35 The AcSB received feedback from stakeholders commenting that an exception should be made to allow the use of a funding valuation for defined benefit plans that do not have a funding valuation requirement. Stakeholders suggested that the exception to use a funding valuation should apply to an unfunded plan that has a direct connection to a funded plan where a funding valuation is used for accounting purposes. The Board discussed this recommendation, noting that adding an exception would allow current diversity in practice to persist. Upon deliberation, the Board decided that the accommodation would be removed, with no exceptions provided.

EFFECTIVE DATE

36 The AcSB proposed an effective date of fiscal years beginning on or after January 1, 2021. Upon finalizing the amendments, the Board decided to extend the effective date by one year to January 1, 2022. In deciding to extend the effective date, the Board considered that the amendments were issued later than anticipated, and that stakeholders will need sufficient time to implement the proposed changes and to educate users on the amendments. Earlier application is permitted.

37 The AcSB encourages stakeholders to consider early adoption of the amendments. Particularly, in circumstances where a funding valuation is required to be completed prior to the effective date of the amendments, stakeholders are encouraged to consider completing the required accounting valuation for unfunded plans at the same time.

TRANSITION

38 In the absence of specific transitional provisions, ACCOUNTING CHANGES, Section 1506, requires amendments be applied retrospectively, except if impracticable.

Defined benefit plans with a funding valuation requirement

39 From consultations with its Committee and actuaries, the AcSB understands that not all enterprises have completed funding valuations determined in accordance with all legislative, regulatory or contractual requirements in effect at the date that the amendments would be first applied.

40 The AcSB thinks that it is important to provide transitional relief. As such, the Board decided not to require an enterprise to obtain a new funding valuation on transition. Accordingly, these enterprises may wait until they are required to obtain an updated valuation. If the enterprise has a funding valuation completed in accordance with legislative requirements in effect at the transition date, for example, a funding valuation for an Ontario plan that discloses the amount of regulatory provision required to fund PfAD, the enterprise should use this funding valuation. In addition, enterprises would not be required to make retrospective adjustments for the effect of the amendments.

41 The following example illustrates how the transitional provisions would be applied when an enterprise has a completed funding valuation determined in accordance with all legislative, regulatory or contractual requirements in effect at the date that the amendments would be first applied:

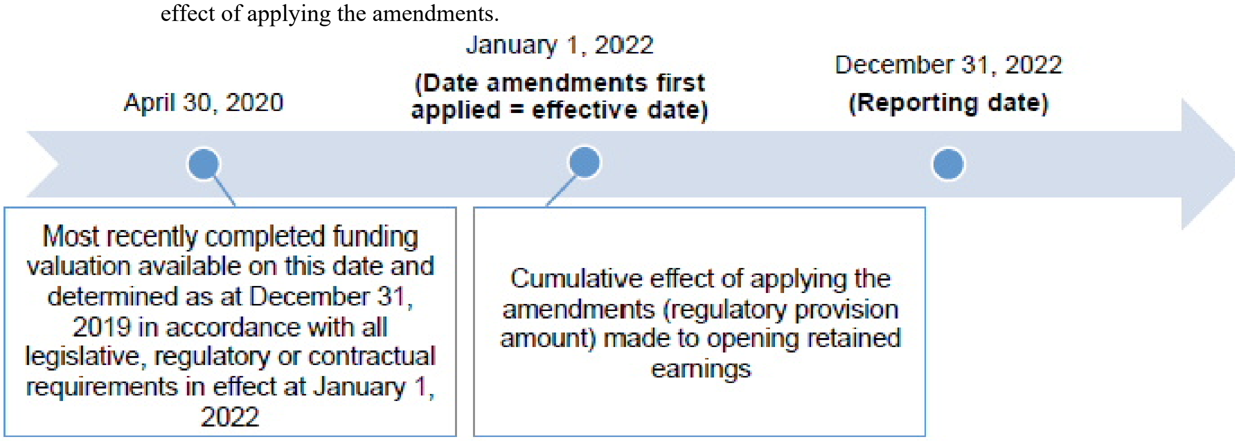
Example 1

A defined benefit plan has a most recently completed funding valuation determined in accordance with all legislative, regulatory or contractual requirements in effect at January 1, 2022, which is the date the amendments are first applied.

This completed funding valuation, which is available on April 30, 2020, discloses the amount of regulatory provision required as at December 31, 2019. The enterprise issues its financial statements on March 31, 2020.

In this scenario, transition would be accounted for as follows:

- Follow guidance on remeasurement in paragraphs 3462.062-.064 to roll forward the DBO, including the regulatory provision from December 31, 2019, by taking into account the following:
  - the increase in the DBO and the regulatory provision due to the passage of time from December 31, 2019, to January 1, 2022, the date the amendments are first applied;
  - the increase in the DBO and the regulatory provision due to the rendering of services for 2020 and 2021; and
  - any benefit payments for 2020 and 2021.
- Adjust opening retained earnings at January 1, 2022 for the regulatory provision amount, which is the cumulative effect of applying the amendments.



- Use the same roll-forward approach to estimate the DBO at December 31, 2022 by taking into account:
  - the increase in the DBO and the regulatory provision due to the passage of time from January 1, 2022 to the reporting date of December 31, 2022;
  - the increase in the DBO and the regulatory provision due to the rendering of services for 2022; and
  - any benefit payments for 2022

42 The following example illustrates how the transitional provisions would be applied when an enterprise does not have a completed funding valuation determined in accordance with all legislative, regulatory or contractual requirements in effect at the date the amendments would be first applied.

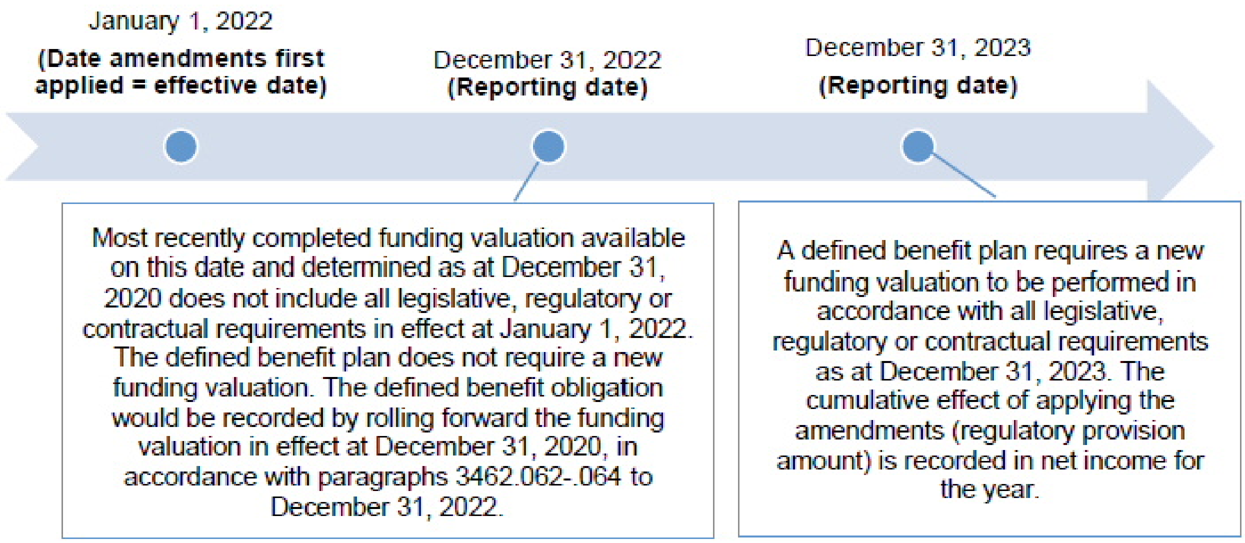
Example 2

A defined benefit plan has a most recently completed funding valuation as at December 31, 2020. The funding valuation has not been determined in accordance with all legislative, regulatory or contractual requirements in effect at January 1, 2022.

The defined benefit plan is required to obtain a new funding valuation in accordance with all legislative, regulatory or contractual requirements in effect at January 1, 2022, as at December 31, 2023. This completed funding valuation will be available on March 31, 2024.

In this scenario, the defined benefit plan is not required to obtain a new funding valuation as at December 31, 2022. The DBO would be recorded by rolling forward the funding valuation in effect at December 31, 2020, in accordance with paragraphs 3462.062-.064 to December 31, 2022.

For the year ended December 31, 2023, the transition would be accounted for by applying the amendments prospectively as defined in ACCOUNTING CHANGES, paragraph 1506.05(g). The enterprise would record the regulatory provision amount, the effect of applying the amendments in net income for the year. The defined benefit plan is not required to retrospectively adjust for the new funding valuation.



Defined benefit plans without a funding valuation requirement

43 The AcSB decided that enterprises with defined benefit plans without a funding valuation requirement should also be provided with transitional relief from retrospective application of the amendments. Thus, when an enterprise is required to change its accounting policy from using a funding valuation to an accounting valuation, it would record the cumulative effect of applying the amendments in opening retained earnings at the date that the amendments would be first applied.

OTHER CONSEQUENTIAL AMENDMENTS

44 The amendments would affect other Sections. The rationale for some of the more significant amendments are described below.

ACCOUNTING CHANGES, Section 1506

45 ACCOUNTING CHANGES, paragraph 1506.09(e), permits an entity to change its accounting policy to measure a DBO for which an appropriate funding valuation has been prepared using that funding valuation or a separate actuarial valuation prepared for accounting purposes without meeting the criterion in paragraph 1506.06(b). As a result of the amendments to remove the accommodation to allow the use of a funding valuation for defined benefit plans without a funding valuation requirement when certain conditions have been met, the AcSB decided to amend paragraph 1506.09(e) so that it only applies to defined benefit plans with a funding valuation requirement.

REPORTING EMPLOYEE FUTURE BENEFITS BY NOT-FOR-PROFIT ORGANIZATIONS, Section 3463, in Part III of the Handbook

46 REPORTING EMPLOYEE FUTURE BENEFITS BY NOT-FOR-PROFIT ORGANIZATIONS, paragraphs 3463.06-.07, provide transition guidance to an organization that applies Section 3463 for the first time. However, these paragraphs do not currently indicate that they apply on first-time adoption of the Section. For greater certainty, the AcSB decided to amend Section 3463 to add some words to that effect.

CONFORMING AMENDMENTS

47 The AcSB made conforming amendments to all paragraphs in Section 3462 to replace "entity" with "enterprise".

EXPOSURE FOR COMMENT

48 After resolving the issues arising from the exposure draft process, the AcSB considered, as part of its due process, whether revisions to the proposals should be exposed for comment.

49 The revisions have been highlighted in the relevant sections throughout the Basis for Conclusions. These revisions consist of changes and clarifications to reduce complexity, based on feedback received from stakeholders. Other than the changes and clarifications already highlighted in the Basis for Conclusions, only minor drafting changes were made. Therefore, the AcSB decided that there was no need for re-exposure.
