

ASSURANCE AND ACCOUNTING

ASPE'S IMMEDIATE RECOGNITION METHOD: A SIMPLIFICATION TO POST EMPLOYEE BENEFIT ACCOUNTING

One of the most complicated areas of accounting is the accounting for defined benefit employee future benefit plans. These complications are caused by various factors including:

- The need for actuarial valuations;
- The fact that actuarial techniques used for accounting purposes differ from those used for funding purposes; and
- The various smoothing mechanisms that exist to limit the impact of significant changes in actuarial calculations on net income.

The adoption of Accounting Standards for Private Enterprises¹ (ASPE), will allow entities the option of adopting a simplified approach to accounting for defined benefit plans. This method is referred to as the Immediate Recognition Method. Although it is easier to apply, this approach will result in greater volatility in net income as it does not allow the deferral and amortization of actuarial gains or losses or past service costs. For entities with debt covenants or any other contracts which are impacted by net income, this volatility should be considered when making the accounting policy choice. If an entity chooses to use the Immediate Recognition Method, it must be applied to all plans.

Application of the Immediate Recognition Method

The Immediate Recognition Method requires the recognition of the accrued benefit obligation net of the fair value of the plan assets on the balance sheet with all costs recognized during the year. If required, any asset must be adjusted for any valuation allowance. This approach results in all changes in the asset or liability being recognized immediately, which is why it is referred to as the Immediate Recognition Method. An example of the applying the immediate recognition approach is provided in Appendix A.

Accrued Benefit Obligation

As mentioned above, one of the complicating factors of accounting for defined benefit plans was the fact that the valuation techniques used for accounting purposes differs from those used for funding purposes. This factor results in increased costs, as entities were required to obtain two actuarial valuations. The Immediate Recognition Method only requires the use of the valuation prepared for funding purposes.



¹The guidance provided in this publication is also applicable to entities applying Accounting Standards for Not-for-profit Organizations in Part III of the Accounting Handbook.

The funding valuation is only required to be completed every three years, which is consistent with most Canadian pension requirements. The valuation would only be required to be performed more frequently if a significant event took place, such as, a settlement, curtailment or a plan amendment that results in past service costs. Otherwise, in the years in between valuations the accrued benefit obligation will be estimated using a roll forward technique that takes the following into account:

- The increase in the obligation due to the passage of time²;
- The increase in the obligation due to the rendering of service in the current year³;

The effects of changes in employee composition and salaries;

- Any benefit payments; and
- Any other significant changes.

Plan Assets

The plan assets are required to be measured at fair value at the balance sheet date, which is typically market value.

Valuation Allowance

If the plan assets exceed the accrued benefit obligation, the need for a valuation allowance must be considered. Any asset recognized on the balance sheet is limited to the extent it is expected to be recoverable by the entity. It is only recoverable to the entity if it can be withdrawn by the entity or if it can reduce future contributions below the current service cost. So in an extreme example, where any surplus cannot be withdrawn, and contributions at a minimum must match the current service cost, a valuation allowance would be needed to reduce the asset to zero.

Cost for the Year

The cost of the plan for the year is expensed in the current year, unless it meets the criteria to be capitalized as an asset (eg. inventory). Assuming the entire amount will be expensed the expense will comprise of:

- Changes in the accrued benefit obligation, other than those resulting from benefit payments to plan members and net of any employee contributions;
- The actual return on plan assets⁴; and
- The change in the valuation allowance, if any.

First-Time Adoption

As entities transition from pre-changeover GAAP to ASPE, Section 1500, First-Time Adoption⁵, will be very important. Although Section 1500 generally requires retrospective adoption of ASPE, it provides certain exceptions and exemptions from retrospective application. The following exemption is provided for entities using the immediate recognition approach:

When an entity makes the accounting policy choice at the date of transition to ASPE to measure its benefit obligations using the funding valuation (when one is available) and to recognize all past service costs and actuarial gains and losses in the period they arise, it applies that accounting policy to all comparative years shown.

If this exemption is used it must be applied to all defined benefit plans.

Conclusion

On the adoption of ASPE, the availability of the immediate recognition approach will provide a significant simplification in accounting for defined benefit plans. The price to pay for this simplification is increased volatility in net income. Talk to your BDO advisor to understand the impact it will have on you.

² Calculated by multiplying the obligation at the end of the previous year by the discount rate used in the valuation.

³ Unless provided in the actuarial valuation, it is calculated by multiplying the service cost for the prior year by 1 plus the discount rate used in the valuation.

⁴ Determined by calculating the difference between the fair value of the assets at the beginning of the year, reduced for any benefit payments and increased by any contributions; and the fair value of the plan assets at the end of the year.

⁵ For NPOs, the Standard is Section 1501, First-time Adoption in Part III of the CICA Handbook – Accounting.

Appendix A

Example of Application of the Immediate Recognition Method

Excerpts from an Actuarial Valuation Report of an Individual Pension Plan

According to paragraph 8515 of the Income Tax Regulations, the Plan is a "designated plan". Therefore, the maximum eligible Plan Sponsor's contributions must be computed using actuarial assumptions and methods ("the maximum funding basis") prescribed by the Canada Revenue Agency ("CRA").

CRA prescribes the maximum funding basis for designated plans. The Plan Sponsor can contribute any amount up to the maximum contributions computed on the basis. In today's economic environment, the set of actuarial assumptions that we would select produces going-concern funding requirements that are above the maximum funding basis. In addition, it is the Plan Sponsor's objective to provide maximum funding of the Plan. Therefore, for this and subsequent valuations, the going-concern basis will be the maximum funding basis.

The financial position of the plan has been valued using 2 actuarial bases, namely: the maximum funding basis prescribed by paragraphs 8515 (5), (6) and (7) of the Income Tax Regulations for designated plans; and the solvency basis used to indicate the financial position of the Plan as if it were totally terminated at the valuation date.

The following table indicates the actuarial assumptions and methods used under each basis:

	Maximum Funding Basis	Solvency Basis
Interest rate	7.5% per year	2.5% per year for the first 10 years following the valuation date and 3.5% thereafter
Salary increase	5.5% per year	No increase
Inflation	4% per year	As built into solvency interest rates
Maximum pension	\$2,444.44 per year of service in 2009 increasing at 5.5% per year thereafter	\$2,444.44 per year of credited service
Retirement age	Age 65, or latest retirement age allowed under plan text if over 65 at valuation date	Age 65, immediately if eligible, with grow-in rights in Ontario
Form of pension	Joint life pension reducing by 1/3 on the member's death, with a 5 year guarantee	Idem
Marital status	100% married at retirement with spouse of the same age	Idem
Pension indexation	3%	In accordance with CPI
Expenses	None	\$5,000
Termination rates	None	None
Mortality rates	80% of average GAM-83 male and female mortality rates (after retirement only)	UP94 projected to 2015 (after retirement only)
Actuarial cost method	Projected Accrued Benefit	Accrued Benefit
Value of assets	Market value	Market value

Financial Position of Plan As at January 1, 2011

	Maximum Funding Basis	Solvency Basis
Assets	\$ 276,322	\$349,500
Liabilities	(\$ 425,300)	(\$ 637,800)
Expenses	(\$ NIL)	(\$ 5,000)
Excess assets (Deficit)	(\$148,978)	(\$ 293,500)

Minimum special payments must be made to liquidate any funding deficit over 15 years and any solvency deficit over 5 years. These special payments are summarized in the following table:

	Maximum Funding	Solvency	Total
2011	\$ 16,291	\$ 63,166	\$ 79,457
2012	\$ 16,291	\$ 63,166	\$ 79,457
2013	\$ 16,291	\$ 63,166	\$ 79,457

The current service costs for years following the valuation date are shown in the following table:

	Member	Plan Sponsor	Total
2011	\$ NIL	\$ 25,400	\$ 25,400
2012	\$ NIL	\$ 25,400	\$ 25,400
2013	\$ NIL	\$ 25,400	\$ 25,400

Information on Plan Assets of an Individual Pension Plan

Market value as at January 1, 2010	\$ 321,211
Contributions	\$ 26,600
Net investment income	(\$ 71,489)
Market value as at January 1, 2011	\$ 276,322
Contributions	\$ 79,457
Net investment income	\$13,721
Market value as at December 31, 2011	\$ 369,500

Calculations

Accrued Benefit Obligation

The accrued benefit obligation is based on the maximum funding bases per the actuarial report. To determine the accrued benefit obligation at December 31, 2011 the accrued benefit obligation will be rolled forward from the January 1, 2011 actuarial funding valuation by adding the interest cost which is determined by multiplying the January 1, 2011 balance by the discount rate and adding the current service cost:

January 1, 2011 - \$425,300

December 31, 2011 - $425,300 + (425,300 \times 7.5\%) + 25,400 = \$482,598$

Pension Liability

The pension liability will be recorded as the difference between the accrued benefit obligation and the fair value of the plan assets.

January 1, 2011 - $425,300 - 276,322 = \$148,978$

December 31, 2011 - $482,598 - 369,500 = \$113,098$

Pension Expense for 2011

Pension expense for the year will equal the current service cost plus the interest cost less the return on plan assets. It will also equal the change in the pension liability less contributions for the year.

Pension Expense = $25,400 + (425,300 \times 7.5\%) - 13,721 = \$43,577$

or

Pension Expense = $113,098 - 148,978 + 79,457 = \$43,577$

The information in this publication is current as of June 23rd, 2011.

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