ASSURANCE AND ACCOUNTING

EMPLOYEE FUTURE BENEFITS

What you need to know about Sections 3462 and 3463

Accounting for employee future benefits can be complex, but recent changes to the standards have simplified the accounting for defined benefit plans. This publication will cover the new standards on employee future benefits that have been issued in Part II and Part III of the CPA Canada Handbook. It will cover who these Sections apply to, when they are applicable, the key changes you need to be aware of, the differences between funding and accounting valuations, and the transitional provisions available. A detailed example of how to calculate the defined benefit liability under the new standards is also provided.

Who's affected?

You may be wondering if either of these new Sections are applicable to your entity and if so, when they are effective.

Section 3462, Employee Future Benefits, replaces Section 3461 of the same name in Part II of the CPA Canada Handbook – Accounting Standards for Private Enterprises (ASPE) and it is applicable to:

- Private enterprises that apply ASPE; and
- Pension plans that apply the standards in Part IV of the CPA Canada Handbook – Accounting Standards for Pension Plans, and choose to apply the standards in Part II of the Handbook for issues not addressed in Part IV.

Section 3463, Reporting Employee Future Benefits by Not-for-Profit Organizations, was issued in Part III of the CPA Canada Handbook – Accounting Standards for Not-for-Profit Organizations (ASNPO) and it is applicable to:

- Private sector not-for-profit organizations (NPOs) that follow ASNPO. This Section instructs NPOs to follow the requirements of Section 3462 in Part II of the Handbook, except for, specific guidance on the recognition and presentation of remeasurements and other items and the transitional provisions which are contained in Section 3463.

Both of these Sections are applicable for annual financial statements relating to fiscal years beginning on or after January 1, 2014. Earlier application is permitted, but only for all of an entity's benefit plans.

Key Changes

The following chart outlines the key changes in recognition, measurement, presentation and disclosure between previous Section 3461 and new Sections 3462 and 3463:

Change	Section 3461	Section 3462	Section 3463
Defined Benefit Plans			
Elimination of the deferral and amortization approach	Included an option to account for defined benefit plans using either: • The deferral and amortization approach; or • The immediate recognition approach.	The deferral and amortization approach has been eliminated. Now all defined benefit plans must be accounted for using an approach that results in the recognition of the full amount of the defined benefit obligation, net of plan assets, on the balance sheet (subject to a ceiling test for a net asset).	NPOs follow Section 3462.
Measurement date	Allowed plan obligations and plan assets to be measured up to three months prior to the balance sheet date.	No such allowance available. Instead, plan obligations and plan assets must be measured at the balance sheet date.	NPOs follow Section 3462.
Use of a funding valuation	• If an entity was using the deferral and amortization method an actuarial valuation prepared for accounting purposes was required to be used. • If an entity was using the immediate recognition approach and an appropriate funding valuation existed for a defined benefit obligation, the entity was required to use that funding valuation.	• If a defined benefit plan has an appropriate funding valuation, the entity can make an accounting policy choice to measure the obligation using that valuation OR using a valuation prepared for accounting purposes. The same choice must be applied to all such plans. • For other plans, an accounting valuation must be used to measure the obligation.	NPOs follow Section 3462.

Recognition, presentation and disclosure of remeasurements and other items[1]	Section 3461 did not use this specific terminology, however, the components of remeasurements and other items were present under Section 3461.
	• If an entity was using the deferral and amortization method:
	  • Actuarial gains and losses, and past service cost were deferred and amortized; and
	  • All of the other components were recognized in net income in the period they occurred.
	• If the entity was using the immediate recognition method all of these components were recognized in net income in the period they occurred.
		• Remeasurements and other items are recognized in net income in the period they occur.
		• The amount of remeasurements and other items must be disclosed in the notes to the financial statements unless it is separately presented on the face of the income statement.
			• Remeasurements and other items are recognized directly in net assets in the period they occur.
			• Remeasurements and other items are presented as a separate line item on the statement of changes in net assets.

Defined Contribution Plans			
Recognition of past service costs	Past service costs were amortized over the period during which the economic benefits from the plan initiation or amendment were expected to be realized.	Past service costs are recognized in the period when the plan is initiated or the period in which the plan amendment is agreed to.	NPOs follow Section 3462.

[1] Section 3462.006(z) defines remeasurements and other items as comprising the aggregate of: the difference between the actual return on plan assets and the return calculated using the discount rate used to determine the defined benefit obligation; actuarial gains and losses; the effect of any valuation allowance in the case of a net defined benefit asset, determined in accordance with paragraph 3462.086; past service costs; and gains and losses arising from settlements and curtailments.

Calculating the Defined Benefit Liability

As outlined above, the deferral and amortization approach has been eliminated and as a result entities that previously followed that method will no longer be able to amortize actuarial gains and losses, but instead must recognize them in the period they occur. This will have an impact on the calculation of the defined benefit liability. Here is a simple example that illustrates what the impact could look like when calculating the defined benefit liability under the deferral and amortization approach and under the new model using an actuarial valuation prepared for accounting purposes.

Defined[2] benefit liability components	Previous Section 3461 – Deferral and amortization approach	New Section 3462 – New method using an actuarial valuation prepared for accounting purposes
Defined benefit obligation	$50,000	$50,000
Less: fair value of plan assets	(35,000)	(35,000)
Funded status - plan deficit	**$15,000**	**$15,000**
Less: unamortized actuarial losses	(3,000)	0
Less: unamortized past service cost	(2,500)	0
Defined benefit liability	**$9,500**	**$15,000**

As this example shows, the defined benefit liability would be higher under the new method since the actuarial loss and past service cost must be recognized in current year net income instead of deferred and amortized over time. For private enterprises this will result in more volatility in the income statement.

However, NPOs will not see volatility as a result of these items in the statement of operations. This is because the actuarial loss and past service cost amounts are part of remeasurements and other items which NPOs recognize directly in net assets.

See Appendix A for a detailed example of how to calculate the defined benefit liability under the new method when an entity is using a funding valuation.

Funding Valuations and Accounting Valuations

You may be wondering what the differences are between a valuation prepared for funding purposes and one prepared for accounting purposes and which one needs to be used when under the new standards.

Each type of valuation has a different objective and may use different actuarial assumptions which would result in different obligation and cost numbers.

- A **funding valuation** is prepared in accordance with pension legislation and regulations and its purpose is to determine the required cash contributions to the plan.
- An **accounting valuation** is prepared in accordance with generally accepted accounting principles using management's best estimates and the discount rate required by paragraph 3462.047.

The main differences between the two types of valuations are outlined below:

Main Differences	Funding Valuation	Accounting Valuation
Obligation	Reflects the value of benefits earned on the valuation date, but does not include: constructive obligations, improvements for future service or future salary increases.	Includes: constructive obligations, improvements for future service and future salary increases.
Cost method	Varies as permitted by pension legislation and actuarial standards.	Depends on whether future salary levels or cost escalation affect the amount of the employee future benefits. When they do, the projected benefit method is used. When they do not, the accumulated benefit method is used.
Assumptions	The actuary is responsible for the selection of the assumptions, with input from the plan sponsor, and the discount rate is the expected rate of return on assets, net of fees and adjustments for margins for adverse deviations as selected by the plan sponsor.	Management is responsible for the selection of the assumptions, and the discount rate used is either the yield on high quality corporate bonds of the same duration as plan obligations or the interest rate inherent in the amount at which the defined obligation could be settled.

[2] Note: under Section 3461 the word "accrued" in this example would have been used instead of the word "defined".

Under Section 3462, if an appropriate funding valuation for an entity's defined benefit plan(s) has been prepared, the entity must make an accounting policy choice to use either the funding valuation or an actuarial valuation prepared for accounting purposes in measuring the defined benefit obligation. The same choice must be applied to all of the entity's defined benefit plans. An entity can make a free choice to change this accounting policy in the future, but must apply the change retrospectively in accordance with Section 1506, Accounting Changes, except as specified in paragraph 3462.033.

The following chart illustrates when a funding valuation or an accounting valuation can be used depending on the type of defined benefit plan an entity sponsors:

	Type of defined benefit plan(s) an entity sponsors		
Type of actuarial valuation	**Funded Defined Benefit Pension Plan**	**Funded Defined Benefit Pension Plan AND Other Unfunded Defined Post-Retirement Benefits**	**Unfunded Defined Post-Retirement Benefits**
Funding valuation	Yes, a funding valuation can be used in this situation.	Yes, a funding valuation can be used for the entity's defined benefit pension plan. If the entity has chosen to use a funding valuation for its pension plan, then paragraph 3462.031 allows the entity to also use a funding valuation for its unfunded defined benefit post-retirement plan as long as it is prepared on a basis consistent with the funding valuation.	No, a funding valuation cannot be used in this situation.
Accounting valuation	Yes, an accounting valuation can be used in this situation.	Yes, in this situation the entity can choose to use an accounting valuation for both its defined benefit pension plan and for its other defined post-retirement benefits.	In this situation an accounting valuation must be used.

An actuarial valuation must be obtained at least every three years, but may occur more frequently. For example, a new actuarial valuation would be required when a significant event takes place. Section 3462 provides the following examples of events that may be significant and require a new actuarial valuation to be performed:

- A settlement;
- A curtailment; or
- A plan amendment such as a grant of benefits calculated by reference to past service.

The Section also states that a new actuarial valuation is not required when there is a significant change in the interest rate used in determining the discount rate to measure the defined benefit obligation.

In the years between valuations, the entity estimates the defined benefit obligation by performing a roll-forward technique as outlined in paragraph 3462.062. In doing so, the entity must exercise professional judgment and consider factors such as:

- The amount from the last actuarial determination of the defined benefit obligation;
- The increase in the obligation due to the passage of time (refer to paragraph 3462.064(a) for guidance on how to calculate);
- The increase in the obligation due to the rendering of service in the current year (refer to paragraph 3462.064(b) for guidance on how to calculate); and
- Any benefit payments.

Appendix A provides an example of rolling forward the defined benefit obligation and the current service cost.

Transition

The impact adoption of Section 3462 or Section 3463 will have on an entity depends upon its previous accounting policy choices.

There are three main measurement changes an entity may experience in relation to its defined benefit plans when adopting Section 3462 or Section 3463:

- If an entity was previously using the deferral and amortization method it will be required to adopt the new method;
- An entity may choose to change its actuarial valuation method, from an accounting valuation to a funding valuation or vice versa; and
- If an entity was previously measuring its plan assets and plan obligations at a date that was not the balance sheet date it is now required to measure these items at balance sheet date.

For an entity's defined contribution plans the major change upon adoption of Section 3462 or Section 3463 is that past service costs can no longer be deferred and amortized.

Both Section 3462 and Section 3463 are required to be adopted retrospectively in accordance with Section 1506, Accounting Changes, except for the following transitional relief provisions:

- When a private enterprise applies Section 3462 or a NPO applies Section 3463 if that entity previously capitalized employee benefit costs in the carrying amount of assets such as inventories or property, plant and equipment, the carrying amount of those assets does not need to be restated.
- For entities that were previously following either the immediate recognition method or the deferral and amortization method under Section 3461 and were measuring their plan obligations and plan assets at a date that was not the balance sheet date, transitional provisions have been included in Section 3462 paragraphs .122-.124 and in Section 3463 paragraph .07 for private enterprises and NPOs respectively, to help them deal with this change without requiring a new valuation of plan assets and the defined benefit obligation to be obtained on adoption.

Conclusion

As can be seen from the above discussion, entities previously following the immediate recognition method under Section 3461, will likely see few changes upon the adoption of either Section 3462 or Section 3463.

Entities previously following the deferral and amortization method under Section 3461, will see a significant simplification in accounting for defined benefit plans with the adoption of Section 3462 or Section 3463. However, for private enterprises this simplification will result in increased volatility in net income since actuarial gains and losses and past service costs will no longer be deferred and amortized. Volatility in the statement of operations will not be a significant issue for private sector NPOs as these changes will be recognized directly in net assets. Both private enterprises and private sector NPOs should contact their BDO advisor to understand the impact these new standards will have on them.

For additional information on the requirements of Section 3462 and Section 3463 refer to the following At a Glance publications available on bdo.ca: *ASPE at a Glance: Section 3462 – Employee Future Benefits* and *ASNPO at a Glance: Section 3463 – Reporting Employee Future Benefits by Not-for-Profit Organizations*.

The information in this publication is current as of September 3rd, 2014.

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APPENDIX A: CALCULATION OF THE DEFINED BENEFIT LIABILITY AND THE DEFINED BENEFIT COST

In this example we will look at how to roll-forward the defined benefit obligation, calculate the defined benefit liability at year end, December 31, 2015, and calculate the defined benefit cost for the 2015 year under Section 3462.

Scenario: ABC Inc. is a private company that follows ASPE. The entity sponsors a defined benefit pension plan. ABC Inc. has previously made an accounting policy choice to use a funding valuation. The most recent funding valuation is as of December 31, 2014. The entity has a December 31st year end. This is not the year of transition to Section 3462.

Information and assumptions from the valuation and from the entity are as follows:

- Discount rate is 5%;
- Fair value of the plan assets at December 31,2014 was $1,500,000;
- Defined benefit obligation at December 31, 2014 was $1,850,000;
- Current service cost (net of employee contributions) for the year ended December 31, 2014 was $110,000;
- Employer contributions for 2015 are $120,000 – made throughout the year;
- Employee contributions for 2015 are $40,000 – made throughout the year;
- Benefits paid to the employees in 2015 are $30,000; and
- Fair value of the plan assets at December 31, 2015 is $1,700,000.

The first step is to calculate the actual return on plan assets for the year.

Step 1: Calculate the actual return on plan assets for the year

Fair value of plan assets at December 31, 2014	$1,500,000
Add: contributions made during the year (employer + employee) = ($120,000 + $40,000)	160,000
Less: benefit payments made during the year	(30,000)
Subtotal	**$1,630,000**
Fair value of plan assets at December 31, 2015	$1,700,000
Actual return on plan assets for 2015	**$70,000**

Next, we need to calculate the expected return on plan assets for the year using the discount rate required in paragraph 3462.084.

Step 2: Calculate the expected return on plan assets for the year

Fair value of plan assets at December 31, 2014	$1,500,000
Add: average contributions made during the year (employer + employee) = [($120,000 + $40,000) / 2]	80,000
Less: average benefit payments made during the year ($30,000 / 2)	(15,000)
Subtotal	**$1,565,000**
Multiplied by the discount rate	x 5%
Expected return on plan assets for 2015	**$78,250**

Now we can calculate the difference between the actual and expected return on plan assets for the year.

Step 3: Calculate the difference between the actual and expected return on plan assets

Actual return on plan assets (Step 1)	$70,000
Less: expected return on plan assets (Step 2)	78,250
Difference between the actual and expected return on plan assets	**($8,250)**

The next step is to roll forward the amount of the current service cost (net of employee contributions) to year end as the value we have been given above is for the year ended December 31, 2014. According to paragraph 3462.064(b) we do this by multiplying the current service cost amount for 2014 by (1 + discount rate of 5%).

Step 4: Roll-forward the current service cost

Current service cost net of employee contributions at December 31, 2014	$110,000
Multiply by 1 + the discount rate of 5%	1.05
Current service cost net of employee contributions at December 31, 2015	**$115,500**

Next, we need to determine the interest cost on the defined benefit obligation for the year.

Step 5: Calculate the interest cost on the defined benefit obligation

Defined benefit obligation at December 31, 2014	($1,850,000)
Add: average current service cost = [(current service cost net of employee contributions + employee contributions) / 2] = [($115,500 + $40,000) / 2]	(77,750)
Less: average benefit payments made during the year ($30,000 / 2)	15,000
Defined benefit obligation – average balance for the year	**($1,912,750)**
Multiplied by the discount rate	x 5%
Interest cost on defined benefit obligation	**($95,638)**

Then we need to roll forward the defined benefit obligation amount we know as of December 31, 2014 to its December 31, 2015 year end value. According to paragraph 3462.062, to do this we need to take into account the increase in the obligation due to the passage of time, the increase in the obligation due to the rendering of services in the current year, and any benefit payments made during the year.

Step 6: Calculate the defined benefit obligation at year end

Defined benefit obligation at December 31, 2014	($1,850,000)
Add: interest cost on defined benefit obligation (Step 5)	(95,638)
Add: current service cost = (current service cost, net of employee contributions + employee contributions) = ($115,500 + $40,000)	(155,500)
Less: benefit payments	30,000
Defined benefit obligation at December 31, 2015	**($2,071,138)**

Now that we know the defined benefit obligation at the end of the year, and since we have been given the fair value of the plan assets at the end of the year, we can calculate the defined benefit liability at year end.

Step 7: Calculate the defined benefit liability at year end

Defined benefit obligation at December 31, 2015 (Step 6)	($2,071,138)
Fair value of plan assets at December 31, 2015	1,700,000
Defined benefit liability at December 31, 2015	**($371,138)**

This defined benefit liability amount will be recognized on the balance sheet at December 31, 2015.

Finally, we can calculate the defined benefit cost (i.e. the pension expense) for the year. According to paragraph 3462.079, the cost of the pension plan for the year consists of the current service cost, finance cost and remeasurements and other items.

Step 8: Calculate the defined benefit cost for the year

Current service cost, net of employee contributions	$115,500
Net finance cost = (interest cost on defined benefit obligation - expected interest on plan assets) = ($95,638 - $78,250)	17,388
Remeasurements and other items (per 3462.085) = the difference between the actual return on plan assets and the return calculated using the discount rate referred to in paragraph 3462.084 + actuarial gains and losses + the effect of any valuation allowance in the case of a net defined benefit asset + past service costs + gains and losses arising from settlements and curtailments = ($8,250 + $0 + $0 + $0 + $0)	8,250
Defined benefit cost for 2015	**$141,138**

The defined benefit cost for the year would be recognized in net income for ABC Inc.

If the entity was a not-for-profit organization, then the “remeasurements and other items” portion of the defined benefit cost for the year would be recognized directly in net assets.

It should be noted that actuarial gains and losses will only occur in the year a valuation is performed, they will not occur in the years between valuations when we are rolling forward the defined benefit obligation.

We can now do a check to prove the closing defined benefit liability of $371,138 that we calculated in Step 7 by performing the following calculation.

Proof of defined benefit liability at December 31, 2015

Defined benefit liability at December 31, 2014 = [($1,850,000) + $1,500,000]	($350,000)
Add: defined benefit cost for 2015	(141,138)
Less: employer contributions for 2015	120,000
	($371,138)