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## IFRIC: another nail in DB's coffin?

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When Canadian companies first report under the International Financial Reporting Standards (IFRS) they may notice some unintended consequences to their shareholders' equity. The culprit is IFRIC 14 of IAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction. IAS 19 is the standard that the International Accounting Standards Board (IASB) has set for defined benefit (DB) pension plans, and, unless delayed or amended, could spell trouble for Canada's beleaguered DB plan sponsors.

### The current picture

Canadian pension plans are valued under at least three different scenarios: funding, solvency (windup), and accounting. The solvency and windup valuations can be different, but both assume the plan is being wound up. The funding and accounting valuations are usually done on a going concern basis. Often the accounting deficit is less than the solvency deficit but greater than the funding deficit.

Actuaries value pension liabilities by determining expected future pension payments, then calculating the present value of these payments at an assumed discount rate, one for each of the three scenarios. The accounting discount rate is based on high-quality corporate bond yields, the solvency discount rate on government bond yields, and the funding discount rate is usually based on the expected long-term asset return.

Neither the funding deficit nor the windup/solvency deficit (or surpluses) appear in a company's financial statements. They appear in the actuarial valuation report. Legislated minimum funding requirements also appear in the actuarial valuation report.

### How IFRIC will change the picture

For most of the countries that have adopted IFRS, the accounting standards for defined benefit pension plans are identical. However, for a handful of countries, IFRS requires the recording of additional liabilities for legislated minimum funding. Canada is about to join that select group of countries.

The IFRIC believes that legislated minimum funding requirements should be recognized as a liability to the sponsor. IFRIC 14 adjusts the accounting deficit or surplus to reflect minimum funding rules. In Canada this would include the contributions required to fund the solvency deficits.

While many countries in Europe and North America base their pension plan accounting on corporate bond yields, IFRIC 14 will force Canadian companies to reflect Ontario's solvency liability in their balance sheet. For all practical purposes, this results in Canadian companies valuing their accounting liabilities using government bond yields rather than corporate bond yields. IFRIC 14 could therefore put Canada at a competitive disadvantage to other countries.

### Bad timing

Canadian companies will continue to report under Canadian standards during 2010. In their first IFRS report they must include a prior year for comparative purposes.

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The beginning of the prior year is called the date of transition. January 1, 2010 will be the date of transition for many Canadian companies and perhaps Government Business Enterprises (GBEs). Companies must produce an IFRS balance sheet at the date of transition. They must reconcile that balance sheet to the current Canadian balance sheet.

This timing is not good for Canadian sponsors. Solvency funding rules have recently been relaxed, but in the end the solvency and going concern deficits must be funded. (Generally the funding deficit is amortized over fifteen years and the solvency deficit over five years.) Last year's market meltdown has created huge new funding requirements. A significant cash contribution over a period of five to ten years will be required to pay off new solvency deficits, and these payments will make up a good portion of a company's pension contributions for several years.

Although the IFRIC 14 deals with the asset ceiling, it impacts plans currently in a deficit position. IFRIC 14 means that sponsors will have to adjust their shareholder equity to reflect the funding of these solvency deficits.

Current Canadian standards require a plan sponsor to disclose the plan's accounting deficit in the footnotes. Under IFRS, the accounting deficit will move from the footnotes to the balance sheet. And while plan sponsors are expecting a one-time adjustment to equity to reflect that move from the footnotes to the balance sheet, there may be an additional hit to equity due to IFRIC 14.

#### **What can a sponsor do?**

It might be possible to convince the IASB to revise IFRIC 14. IASB is currently revising the interpretation to correct some unintended consequences. Perhaps they would be open to the argument that forcing Canadian companies to essentially use solvency liabilities would be contrary to the principle that liabilities should be valued at fair value. It is difficult to make the case that a hypothetical windup valuation is a "fair value".

Only publicly accountable profit-oriented enterprises must start using IFRS in 2011. However, the Public Sector Accounting Board (PSAB) may partially adopt IFRS. The PSAB has proposed that GBEs adopt IFRS effective January 1, 2011. The PSAB also proposed optional use by Other Government Organizations.

The GBEs and OBOs may want to encourage the PSAB to not implement IFRS effective January 1, 2011. Perhaps they could ask for a delay in implementation. They may need time to measure the impact of IFRIC 14 to their balance sheet. Or time to have their minimum funding requirement changed by their governments.

Once forced to lower equity to reflect a hypothetical windup, shareholders may decide to follow through and actually wind up their plans. The IFRS requirement to lower equity for this funding may quicken the demise of the defined benefit plan in Canada.

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