PUBLIC SECTOR ACCOUNTING BOARD
PSAB CCSP
CONSEIL SUR LA COMPTABILITÉ DANS LE SECTEUR PUBLIC

Invitation to Comment

Public Sector Accounting Board

Employment Benefits: Deferral Provisions in Sections PS 3250 and PS 3255

November 2016

COMMENTS TO PSAB MUST BE RECEIVED BY MARCH 3, 2017

A response form has been posted with this document to assist you in submitting your comments to PSAB. Alternatively, you may send comments via email (in Word format), to:ed.psector@cpacanada.ca addressed to:

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This Invitation to Comment is issued by the Public Sector Accounting Board (PSAB).

Individuals, governments and organizations are invited to send written comments on all aspects of the Invitation to Comment. Comments are requested from those who agree with the Invitation to Comment as well as from those who do not.

All comments received by PSAB will be available on the website shortly after the comment deadline, unless confidentiality is requested. The request for confidentiality must be stated explicitly within the response.

Highlights

This Invitation to Comment sets out the issues and considerations related to a review of the deferral provisions in the Public Sector Accounting Board's (PSAB) standards on employment benefits, including:

- RETIREMENT BENEFITS, Section PS 3250; and
- POST-EMPLOYMENT BENEFITS, COMPENSATED ABSENCES AND TERMINATION BENEFITS, Section PS 3255.

The objectives of this Invitation to Comment are to:

- explain why PSAB is considering whether the deferral provisions in the standards remain appropriate;
- identify potential alternatives and related considerations; and
- seek stakeholder input prior to PSAB establishing its preliminary views on this issue.

Separate invitations to comment will be issued in the future on, for example, discount rates and other aspects of the project PSAB deems necessary to give the issue due attention and consideration. This Invitation to Comment does not cover all aspects of Phase I as it is described in the "Background to the project" section (page ii).

The ultimate objective of this project is to issue a new employment benefits Section in the CPA Canada Public Sector Accounting Handbook, replacing Sections PS 3250 and PS 3255.

Main features

The main features of this Invitation to Comment are as follows:

- There are three deferral provisions in Sections PS 3250 and PS 3255 – two related to deferral and amortization treatment of actuarial gains and losses and one related to valuation of plan assets at market-related values.
- PSAB needs to consider if the deferral provisions in its standards remain appropriate and justified, given that many equivalent employee benefits standards issued by other standard setters have moved away from the deferral approach.
- Understanding the nature of each component of the actuarial gains and losses, and the causes of the changes in them, would help with evaluating the appropriateness of, and justification for, the deferral treatment for each component of the actuarial gains and losses.
- Changes in the value of the accrued benefit obligation that are subject to the deferral treatment can arise from changes in actuarial assumptions (demographic, discount rate and other economic) and experience adjustments.

- Changes in the value of plan assets that are subject to the deferral treatment are the unexpected returns on plan assets.
- Determining the appropriate accounting for each component of the changes in the value of the accrued benefit obligation and plan assets also involves considering:
  - the conceptual soundness of the recognition alternatives;
  - the operating environment in the public sector;
  - the practicality of the overall solution; and
  - if the resulting financial information can stand the test of time.
- Recognition options for each component of the changes in the value of the accrued benefit obligation and plan assets include:
  - recognition in the annual surplus/deficit immediately;
  - recognition in the annual surplus/deficit in subsequent periods (recycling); or
  - no recognition in the annual surplus/deficit (no recycling).
- Valuation options for plan assets include market value only or market-related value (which means market value or a value that is adjusted to the market over a period).

Background to the project

Given the complexity of the issues involved and the potential implications of any changes that may result from a review of Sections PS 3250 and PS 3255, PSAB decided to undertake this project in phases.

Phase I will address specific issues related to the measurement of employment benefits, including the deferral provisions and discount rate guidance in the standards. These are the major areas of differences between PSAB's standards and equivalent standards issued by other accounting standard setters.

The treatment of actuarial gains and losses (deferred or not) and the use of the discount rate to determine the benefit obligation are fundamental to the accounting for all types of employment benefit plans. Addressing these issues first would allow PSAB to make amendments, if necessary, to the standards to enhance the quality of employment benefits financial information reported in financial statements.

Phase II will address:

- the accounting for plans with risk sharing features different from the traditional defined benefit and defined contribution plans (which include, but are not limited to, shared risk or target benefit plans);
- the accounting for multi-employer defined benefit plans and sick leave benefits;

- other improvements to existing guidance; and
- issues that may arise or be identified by stakeholders throughout the development of the project.

PSAB anticipates that more time will be needed to address the non-traditional types of pension plans.

PSAB encourages stakeholders to check the status and background information about this project online or to subscribe to email updates.

Comments requested

PSAB welcomes comments from individuals, governments and organizations on all aspects of the Invitation to Comment.

When comments have been prepared as a result of a consultative process within an organization, it is helpful to identify generically the source of the comment in the response. This will promote understanding of how the issues are affecting various aspects of an organization.

Comments are most helpful if they relate to a specific paragraph or group of paragraphs. Supporting reasons for your comments are most valuable when they demonstrate how they would:

- produce more relevant information for accountability and decision-making by external users;
- improve the representation of the substance of the underlying transaction or event;
- contribute to improved measures and understanding of financial position and annual results;
- facilitate enhanced comparability; and
- provide sufficient information for external users to understand the financial statements.

Please respond to the following questions:

Need for review of deferral provisions

1. Do you agree that PSAB needs to consider whether the deferral provisions in the standards are appropriate?

Components of changes in the accrued benefit obligation and plan assets

2. (a) Which, if any, of the components of the changes in the value of the accrued benefit obligation identified in Chart 2 and paragraphs .015-.056 should be considered separately in determining the accounting for the changes in the

accrued benefit obligation in the statement of operations and the statement of financial position?

(b) Are there any additional components that should be separately identified and considered?

3. Which view of how to break down the investment return component of the changes in the value of plan assets identified in paragraphs .057-.065 is more appropriate for determining the accounting for the changes in plan assets in the statement of operations and the statement of financial position?

4. Are there any other views of how to break down the investment return component of the changes in the value of plan assets that should be considered for determining the accounting for the changes in plan assets in the statement of operations and the statement of financial position?

5. Are there any additional aspects of the components of the changes in the value of the accrued benefit obligation and plan assets that should be considered for determining their accounting in the statement of operations and the statement of financial position that have not been identified in paragraphs .018-.065?

Alternatives and considerations not identified

6. Are there any significant considerations for determining the accounting for each component of the changes in the value of the accrued benefit obligation and plan assets in the statement of operations and the statement of financial position that have not been identified in paragraphs .070-.091?

7. Are there any alternatives for recognition of the changes in the value of the accrued benefit obligation and plan assets in the statement of operations and the statement of financial position that have not been identified in paragraphs .092-.109 and .115-.120?

8. Are there any alternative amortization periods and/or amortization bases under the deferred recognition alternative that have not been identified in paragraphs .110-.114?

9. Are there any alternatives for valuing plan assets that have not been identified in paragraphs .121-.128?

10. Are there any significant arguments relating to any recognition alternatives in the statement of operations (paragraphs .092-.109) and the statement of financial position (paragraphs .115-.120), and plan asset valuation options (paragraphs .121-.128) that have not been identified?

Accounting for each component of changes in the accrued benefit obligation and plan assets

11. How should each component of the changes in the value of the accrued benefit obligation and plan assets be recognized in the statement of operations and the statement of financial position?

12. On what basis should plan assets be valued?

Current accounting practice

13. Do you measure plan assets at market value or market-related value? If market-related value, please describe how it is determined.

14. What is your accounting policy of recognizing actuarial gains and losses (deferred or immediate recognition) arising from post-employment benefits and compensated absences that do not vest or accumulate? Please explain why that accounting policy was chosen.

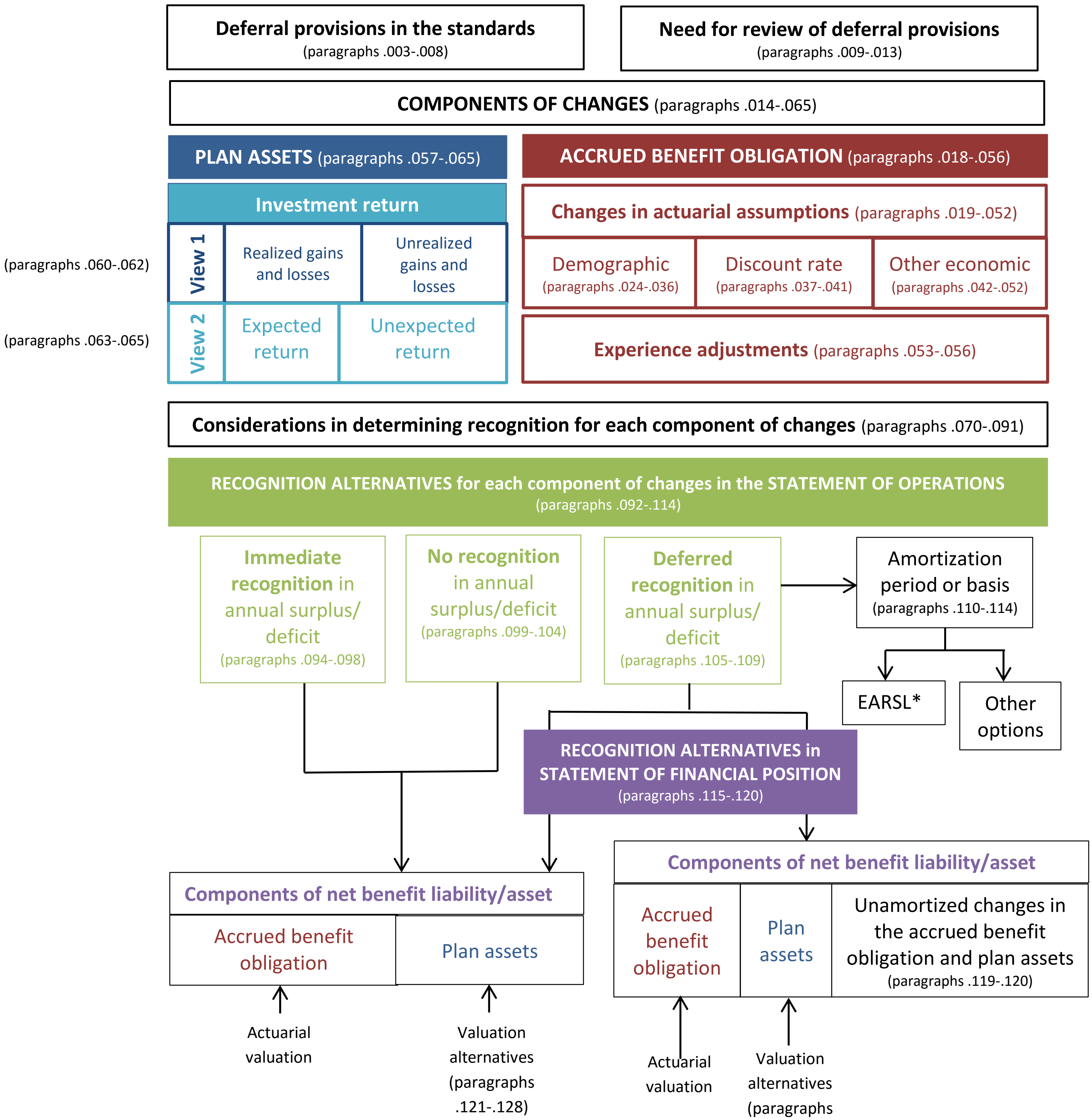
Project issues not identified

15. Are there any specific issues with, or related to, Sections PS 3250 and PS 3255 that have not been identified in the "Background to the project" section (page ii) that PSAB should consider in this project?

Participation in future field tests

16. Would you be interested in participating in future field tests, which may involve using actual benefit plan data to identify the financial implications of various alternatives?

Appendix: Overview of the Invitation to Comment



*EARSL = expected average remaining service life of the related employee group

Employment Benefits: Deferral Provisions in Sections PS 3250 and PS 3255
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Purpose and Scope

.001 This Invitation to Comment addresses the deferral provisions in Sections PS 3250 and PS 3255.

.002 The objectives of this Invitation to Comment are to:

(a) explain why PSAB is considering whether the deferral provisions in the standards remain appropriate;

(b) identify potential alternatives and related considerations; and

(c) seek stakeholder input prior to PSAB establishing its preliminary views on this issue.

Deferral Provisions in the Standards

.003 There are three deferral provisions in Sections PS 3250 and PS 3255:

(a) Actuarial gains and losses arising from defined benefit plans, and those arising from post-employment benefits and compensated absences that vest or accumulate, are recognized over the expected average remaining service life of the related employee group.

(b) Actuarial gains and losses arising from post-employment benefits and compensated absences that do not vest or accumulate can be recognized immediately when they arise or over a period linked to the type of benefit.

(c) Plan assets are valued at market-related values, meaning market value or a value that is adjusted to market value over a period not to exceed five years.

.004 Actuarial gains and losses are defined as changes in the value of the accrued benefit obligation and plan assets resulting from:

(a) experience different from that assumed; or

(b) changes in an actuarial assumption.

.005 Estimating the accrued benefit obligation involves making actuarial assumptions about future events and factors, such as:

(a) general inflation, medical inflation and salary increases;

(b) utilization of medical benefits; and

(c) employee turnover and mortality.

.006 Periodic actuarial valuations of the benefit obligation usually determine that adjustments are required, either due to experience different from that assumed, or to changes in actuarial assumptions. Changes in actuarial assumptions are needed when an entity believes revised assumptions are necessary to reflect a relatively permanent change in expected experience or to reflect new information.

.007 Actuarial gains and losses are recognized over a reasonable future period because:

(a) of their tentative nature; and

(b) further adjustments will likely be required in the future.

.008 Plan assets are adjusted to market value over a period not to exceed five years because this can minimize short-term fluctuations. Market-related values closely approximate current economic value, and are objective and verifiable.

Need for Review of Deferral Provisions

.009 Deferral provisions, such as those in Section PS 3250, were common features in employee benefits standards that have been superseded by other international and national accounting standard setters in the public and private sectors. Some questioned why smoothing is still permitted in public sector financial reporting in Canada. PSAB needs to consider if the deferral provisions in its standards remain appropriate and justified.

.010 The reasons for other standard setters moving away from the deferral approach of pension accounting, as stated in their bases for conclusions, include the following:

(a) Actuarial gains and losses represent changes in estimates. Recognizing actuarial gains and losses in the surplus or deficit in the year they occur is conceptually sound.[1]

(b) Deferral and amortization accounting does not provide a faithful representation of an entity's defined benefit obligations since it excludes the effects of some gains and losses on the reported amount of those obligations.[2]

(c) Delays in the recognition of gains and losses give rise to misleading amounts in the statement of financial position.[3] In some circumstances, this exclusion can result in the reporting of a plan asset even though the plan's obligations exceed its assets.[4]

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1 GRAP 25, *Employee Benefits* — Basis for Conclusions, paragraph BC8.

2 EMPLOYEE FUTURE BENEFITS, Section 3462 — Background Information and Basis for Conclusions, paragraph 3.

3 IAS 19 *Employee Benefits* — Basis for Conclusions, paragraph BC3.

4 EMPLOYEE FUTURE BENEFITS, Section 3462 — Background Information and Basis for Conclusions, paragraph 3.

(d) Deferral and amortization accounting also makes it difficult to understand defined benefit plan costs included in the income statement. Gains and losses related to defined benefit plans are deferred and amortized into income in future years (i.e., “smoothed” into income). Consequently, defined benefit plan costs include amounts resulting from current period activities and the amortization of amounts deferred in prior periods.[5]

(e) Immediate recognition provides information that is more relevant to users of financial statements than the information provided by deferred recognition. It also provides a more faithful representation of the financial effect of defined benefit plans on the entity and is easier for users to understand.[6]

.011 Other employee benefits standards reviewed by PSAB[7] all require:

(a) plan assets to be measured at their fair values; and

(b) no adjustment for unamortized actuarial gains and losses in the defined benefit liability or asset reported in the statement of financial position.

.012 Recognition of the changes in the value of the accrued benefit obligation and plan assets in the statement of operations (or the statement of financial performance or equivalent) varies in other employee benefits standards reviewed by PSAB. The recognition approach in these standards often reflects the financial reporting model in their respective conceptual frameworks.

.013 As illustrated in Chart 1 on the next page, the approaches of other employee benefits standards reviewed by PSAB can be classified into three categories:

(a) Immediate recognition — actuarial gains and losses are recognized in annual surplus/deficit or profit/loss when they arise.

(b) No recognition — actuarial gains and losses are recognized in other comprehensive income or net assets when they arise, and will not be recognized in annual surplus/deficit or profit/loss in subsequent periods (often referred to as “no recycling”).

(c) Deferred recognition — actuarial gains and losses are recognized in other comprehensive income or deferred inflow/outflow of resources when they arise, and will be recognized in annual surplus/deficit or profit/loss in subsequent periods (often referred to as “recycling”).

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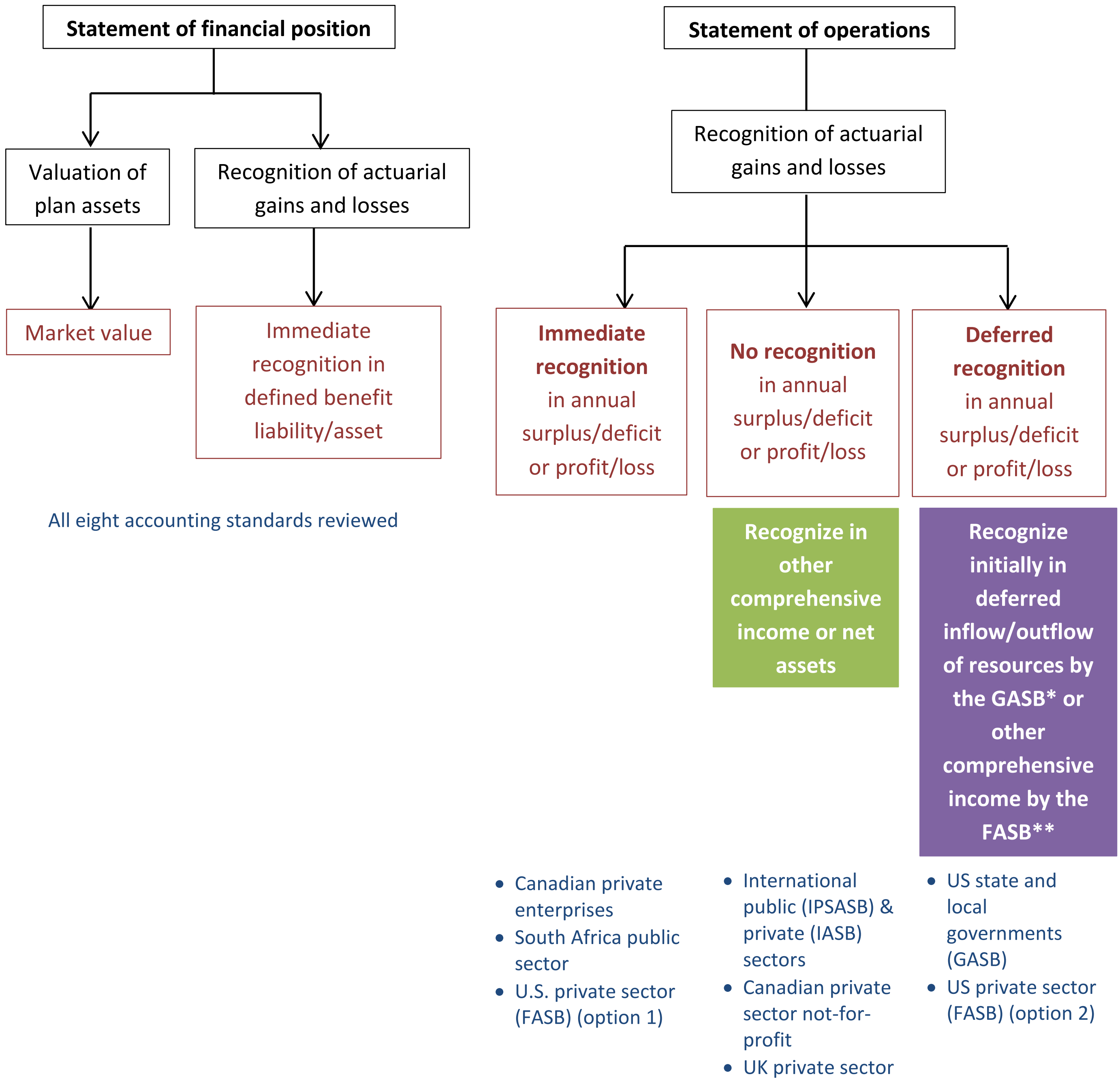
5 EMPLOYEE FUTURE BENEFITS, Section 3462 — Background Information and Basis for Conclusions, paragraph 4.

6 IAS 19 *Employee Benefits* — Basis for Conclusions, paragraph BC70.

7 Including eight accounting standards issued by the International Accounting Standards Board (IASB), the International Public Sector Accounting Standards Board (IPSASB), the US Financial Accounting Standards Board (FASB), the US Governmental Accounting Standards Board (GASB), the UK Accounting Standards Board, the Canadian Accounting Standards Board (AcSB) and the South African Accounting Standards Board.

Chart 1: Approaches taken by employee benefits standards issued by other standard setters



* The GASB requires the unexpected return on plan assets to be amortized over five years, and other actuarial gains and losses amortized over the expected average remaining service life of the related employee group.

** The FASB requires the corridor approach: amortize the excess of the net unamortized actuarial gains and losses over 10 percent of the greater of defined benefit obligation or the market-related value of plan assets at the beginning of the period over the expected average remaining service life of the related employee group, or a shorter period.

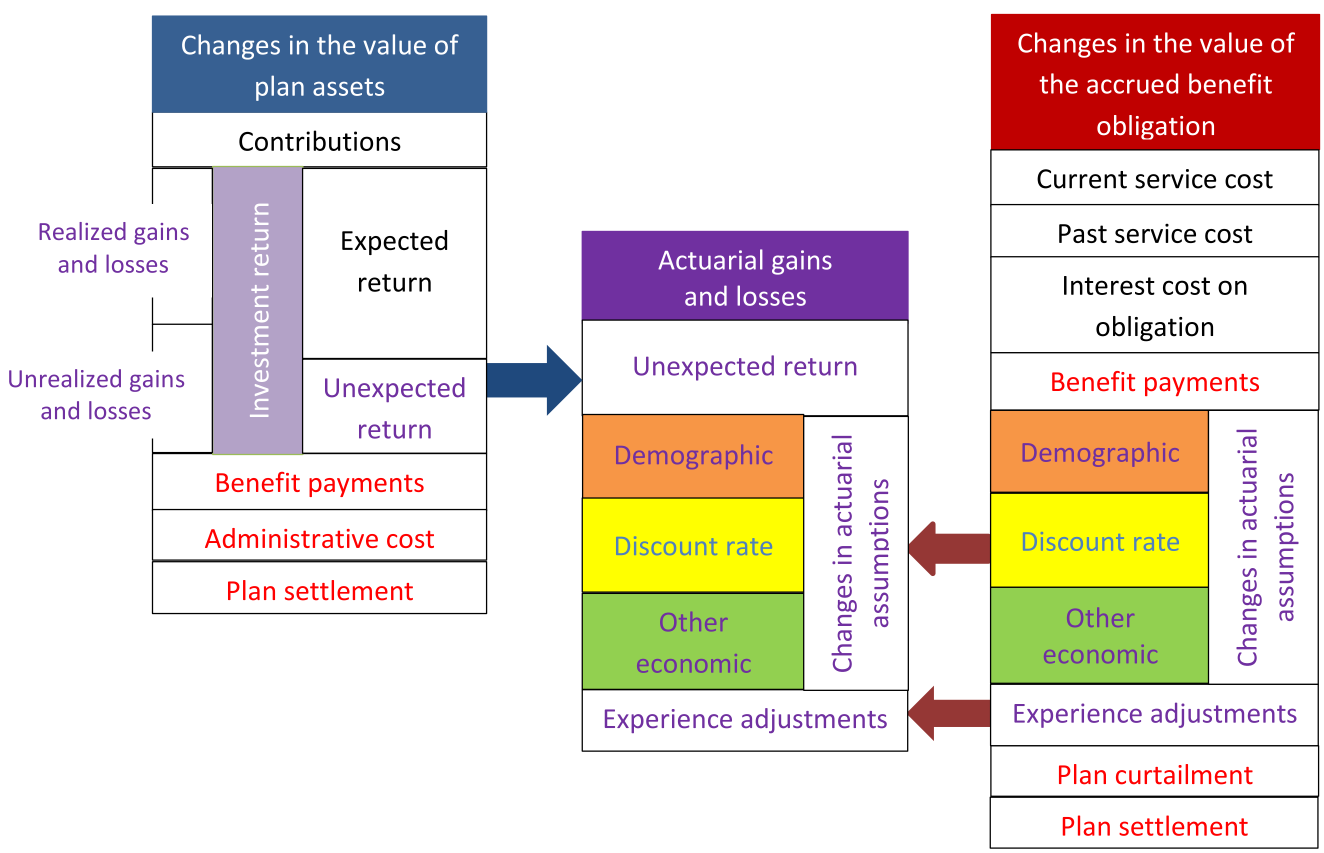
Components of Changes in the Accrued Benefit Obligation and Plan Assets

.014 The deferral approach to pension accounting was introduced in the predecessor standard of Section PS 3250 when public sector entities were first required to report pension liabilities in their financial statements. Section PS 3250 states that actuarial gains and losses are recognized over a reasonable future period because of their tentative nature and because further adjustments will likely be required in the future.

.015 After decades of experience in reporting pension liabilities, public sector entities should have gained a good understanding of the nature of each component of the actuarial gains and losses, and the causes of the changes in them. This understanding should help with evaluating the appropriateness of, and justification for, the deferral treatment for each component of the actuarial gains and losses.

.016 Chart 2 below illustrates the changes that can occur in the value of the accrued benefit obligation and plan assets, if any, in a reporting period.

Chart 2: Changes in the value of the accrued benefit obligation and plan assets



.017 Not all changes in the value of the accrued benefit obligation and plan assets meet the definition of actuarial gains and losses and are subject to deferred recognition in the current standards. Changes that are recognized when they arise (such as current and past service costs, interest cost on benefit obligation, gains and losses on plan curtailments and settlements) are outside the scope of this Invitation to Comment.

Changes in the value of the accrued benefit obligation

.018 Changes in the value of the accrued benefit obligation that are subject to the deferral treatment can arise from:

(a) changes in actuarial assumptions, which include demographic assumptions, the discount rate assumption, and other economic assumptions; and

(b) adjustments from actuarial assumptions to actual experience (i.e., experience adjustments).

Actuarial assumptions

.019 Many employment benefits are payable many years after an employee has rendered the services and over a long period of time. There is uncertainty about the future events and factors that would ultimately determine the cost of the benefit promised. Accounting for the obligation to provide benefits as employees render services requires forecasts of these future events, such as how long the employee and any survivors live, how many years of service the employee renders, and the employee's compensation and retirement age. Such forecasts form the basis of actuarial assumptions.

.020 The key actuarial assumptions used to estimate the benefit obligations can be classified into the following categories:

(a) demographic assumptions, which include assumptions about mortality, retirement, termination and benefit utilization;

(b) the discount rate assumption, which is considered separately from other economic assumptions because its nature is somewhat different; and

(c) other economic assumptions, which include assumptions about general inflation, medical inflation and salary increases.

.021 The discount rate assumption used to estimate the benefit obligation reflects the time value of money. Other economic assumptions are forecasts about future events and factors that directly relate to the benefit formula and the cost of the benefit promised.

.022 Each key actuarial assumption would be based on the entity's best estimate of the future events that have an effect on the accrued benefit obligation. The assumptions would take into account the expected long-term experience of the plan and the short-term forecast. However, assumptions about the long-term future are not to be unduly influenced by the experience expected in the short term. At each actuarial valuation, assumptions need to be reassessed; they would be revised if expectations about the future change.

.023 Under the deferral provisions in Sections PS 3250 and PS 3255, the effect of a change in an actuarial assumption is not recognized in the period that the change is made. Understanding the major drivers behind the changes in each key actuarial assumption would inform the assessment of whether the deferral provisions in these standards remain appropriate and justified.

Demographic assumptions

.024 Demographic assumptions are forecasts about the expected long-term experience of the demographics and behaviors of plan members, survivors and dependents. They affect the timing, duration and the probability that benefit would be payable, which would directly affect the expected cost of the benefit promised.

.025 Key demographic assumptions include forecasts about mortality, retirement, termination and utilization of benefits. Some demographic assumptions may reflect or be based on the demographics and experience of the general or comparable population. Other demographic assumptions may reflect or be based on the specific experience of the employee group of the entity or members of the benefit plan. Benefit plans with a large member group may have credible experience that can be used to determine their own demographic assumptions.

.026 In general, demographic assumptions are relatively stable. They may change because of changes in the long-term experience of the plan or the general population. However, demographic assumptions normally do not change significantly from year to year unless the entity changes the plan provisions in a way that could change the behaviour of plan members.

Mortality

.027 Mortality assumptions are used to estimate the obligation of benefits that are payable in the lifetime of a retiree and a survivor. Mortality assumptions are generally based on age and gender. The actuarial profession publishes mortality tables and mortality improvement scales from time to time to reflect the mortality experience of the general population.

.028 The most recent tables reflect significant mortality improvements from the last published tables. In general, mortality is expected to continue to improve. Except when the mortality tables are updated by the actuarial profession, mortality assumptions (taking into account projected mortality improvement) usually do not change significantly from period to period.

.029 Entities with larger benefit plans may make adjustments to the actuary-published mortality tables or develop their own mortality assumptions based on plan experience. The mortality assumptions of these plans may be updated more frequently than the published tables. The effects of each of the more frequent updates are likely less significant.

Retirement

.030 Retirement assumptions are used to estimate the obligation of benefits that are paid upon retirement. While retirement assumptions are usually based on age and gender, years of service may also be a consideration. For example, if the eligibility criterion for retirement or early retirement is a combination of years of service and age.

.031 Retirement assumptions usually reflect the experience of the entity. Once established, retirement assumptions generally do not change significantly from year to year unless an entity introduces changes in benefit provisions that could affect employees' retirement decision. For example, a change in the retirement assumptions may be triggered by the granting of an early retirement incentive, changes in the eligibility for unreduced benefits, or changes in eligibility or contribution requirement for retiree health and medical benefits.

Termination

.032 Termination means cessation of employment for reasons other than retirement or death. Termination assumptions are used in the estimate of benefits that are based on salary and years of service rendered by an employee. Termination assumptions are generally based on factors, such as age, gender and years of service.

.033 Termination assumptions usually reflect the experience of the entity. Once established, termination assumptions generally do not change significantly from year to year. Even when there are organizational changes in the entity, such as restructuring, downsizing and relocation, the effects of these changes would be recognized as a plan curtailment, not a change in assumptions.

Benefit utilization

.034 Benefit utilization assumptions are used to estimate the obligation of health and medical benefits for retirees. Benefit utilization assumptions are forecasts about:

(a) the level and frequency of expected claims for each type of health and medical benefits covered in the plan; and

(b) plan participation if it is optional and member contribution is required.

.035 The usage of health and medical benefits by retirees and their beneficiaries can be influenced by many factors, for example,

(a) their age, gender and health status;

(b) the availability of new medical treatments, drugs, health products and services;

(c) changes in attitudes and behaviors of the general population, such as healthier lifestyles; and

(d) coverage of government funded benefits.

.036 Benefit utilization assumptions should reflect the claim experience of the benefit plan. However, it can be difficult to isolate the effects of the benefit utilization factors from the effects of the medical inflation factors in the claim experience, which is a major source of information for developing assumptions. In practice, actuaries combine the benefit utilization and medical inflation factors that can influence the benefit claim costs into a single assumption, referred to as the health care trend rate.

Discount rate assumption

.037 The discount rate assumption is used to determine the present value of the benefit obligation at the financial statement date. Benefit obligations are usually settled many years after an employee has rendered the services and over a long period of time. Valuation of the benefit obligation is highly sensitive to the discount rate assumption. A small change in the discount rate assumption can result in a significant effect on the benefit obligation.

.038 In practice, the expected return on plan assets is usually used to determine the present value of the obligations of benefit plans that are funded or partially funded. The entity’s cost of borrowing is usually used to determine the present value of the obligations of benefit plans that are unfunded.

.039 The expected rate of return on plan assets reflects the investment strategies of the benefit plan and the entity’s expected return from investing in the different types of plan assets. A change in the expected rate of return assumption may be triggered by a change in an entity’s long-term view of the market or the plan’s investment strategies.

.040 An entity’s cost of borrowing is generally more volatile as interest rates are affected by changes in economic and market conditions, in addition to an entity’s own credit rating. Market condition can fluctuate from period to period.

.041 PSAB intends to review the discount rate guidance in Section PS 3250 as part of this Employment Benefits project. The treatment of the effect of a change in the discount rate assumption will be considered in conjunction with the discount rate guidance.

Other economic assumptions

.042 Other economic assumptions are economic assumptions other than the discount rate assumption. They are forecasts about future events and factors that are related to the benefit formulae that would directly affect the expected cost of the benefits promised.

.043 Key other economic assumptions include inflation, medical inflation and salary increases. They are affected by the general economic condition, which is often outside the entity's control. They can also be affected by changes in the nature and features of the benefit promised by the entity.

Inflation

.044 An inflation assumption is used to estimate the obligation of benefits that are subject to a cost-of-living adjustment based on the consumer price index (often referred to as "indexation"). Whether a benefit promised is 100, 75 or 50 percent indexed to inflation, or subject to ad hoc indexation based on certain conditions, would have very different cost implications.

.045 Inflation is also a fundamental component of each of the economic assumptions. For example, salary increase, expected rate of return on assets, the cost of borrowing and medical inflation all contain an underlying inflation component. A change in the inflation assumption would trigger a change in each of the economic assumptions.

.046 The inflation assumption reflects the general increase in prices throughout the economy. It is influenced by the general economic and market conditions. The inflation in the Canadian economy has mostly been within the Bank of Canada's one to three percent target range in the past 20 years. The inflation assumption generally does not change significantly from year to year, though the actual experience may fluctuate from year to year.

Salary increase

.047 The salary increase assumption is used to estimate the obligation of benefits that are based on the future salary of an employee. Whether a benefit promised is based on an employee's final, career average, best five-year or best three-year salary would have very different cost implications.

.048 The salary increase assumption reflects an entity's forecast about the expected long-term inflation and general productivity growth, as well as its own seniority and promotion scale. Though salary increase is ultimately a decision of the employer, it is not entirely within its control because the salary offered by an entity would be influenced by inflation and the market demand for workforce.

.049 The long-term salary increase assumption does not change significantly from year to year. However, a change in the salary increase assumption in the short term may be triggered by salary increases promised by the employer or reached with employees in collective bargaining.

Medical inflation

.050 Medical inflation assumptions are used to estimate the obligation of retiree health and medical benefits. They reflect the expected change in the cost of each type of health and medical benefits covered in the plan, taking into account expected technology advances in health care.

.051 Medical inflation can be influenced by many factors, some controllable by the entity and some not. A change in medical inflation assumptions may be triggered by cost containment measures introduced by the entity, such as use of generic drugs, or annual or lifetime maximums. Medical inflation can also be affected by the general inflation level, technological and medical developments, expiration of patents of drugs and other changes in substitution of health products and services.

.052 Valuation of retiree health and medical benefits obligation is highly sensitive to the medical inflation assumptions. In practice, actuaries combine the medical inflation and benefit utilization factors that can affect the benefit claim costs into a single assumption, referred to as the health care trend rate.

Changes in actuarial assumptions and experience adjustments

.053 Because of the inherent uncertainty in the estimate of the benefit obligation, actual experience of events and factors are likely different from the forecasts in actuarial assumptions. Adjustments to the benefit obligation (called experience adjustments) are needed to reflect the actual experience. When significant experience adjustments going in the same direction are required period after period (or valuation after valuation), it may indicate a relatively permanent trend. A change in actuarial assumptions may be needed.

.054 Actuarial assumptions are estimates of future events and factors. Some argue that since experience adjustments and changes in actuarial assumptions both represent adjustments to previous accounting estimates, they should be accounted for in the same way. Others argue that experience adjustments differ from changes in actuarial assumptions. Experience adjustments reflect the difference between actual experience and the previously established assumptions and, therefore, are firmer numbers. Changes in actuarial assumptions reflect changes in the best estimates of uncertain future events.

.055 In certain circumstances, it may not be clear whether a change in the value of the accrued benefit obligation is a change in an actuarial assumption or an experience adjustment. For example, when an entity reaches an agreement with its employees to provide a salary increase in the current year and for the next two years, the salary increase may be considered by some as an experience adjustment and by others a change in the salary increase assumption. This example suggests that experience adjustments and changes in actuarial assumptions may not be substantially different.

.056 Treating a change in the salary increase assumption the same way as an experience adjustment related to a salary increase would avoid the need to distinguish the two. There will be no incentive to classify a change in the accrued benefit obligation as either a change in assumption or an experience adjustment to achieve a particular accounting result.

Changes in the value of plan assets

.057 Not all benefit plans are funded and have plan assets. Some are managed on a pay-as-you-go basis. Consideration of the accounting for changes in the value of plan assets only applies to benefit plans that are funded or partially funded. Chart 2 on page 7 illustrates that there are two ways to break down the investment return component of the changes in the value of plan assets:

(a) realized and unrealized gains and losses; and

(b) expected and unexpected return on investment.

.058 Section PS 3250 is based on the view that the investment return on plan assets is made up of an expected return component and an unexpected return component. The expected return on plan assets is recognized immediately in the annual surplus/deficit. The difference between the actual return and the expected return (i.e., the unexpected return) on plan assets is a component of the actuarial gains and losses, and is recognized over the expected average remaining service life of the related employee group.

.059 The actual investment return on plan assets in a given period is affected by the economic and market conditions during and at the end of the reporting period. As market condition is subject to fluctuations, actual return can fluctuate from year to year. Some argue that, to a certain extent, the entity may mitigate the volatility of the investment return through direct or indirect influence in the investment strategies of plan assets.

Realized and unrealized gains and losses

.060 The view that the investment return on plan assets consists of a realized component and an unrealized component of gains and losses focuses on the economic event or transaction that gives rise to the different components of the investment return.

.061 The realized gains and losses component of the investment return arises from actual transactions occurred in a reporting period. Once earned or settled in a reporting period, they will not be adjusted because of changes in the economic or market conditions in subsequent periods. Realized gains and losses include:

(a) investment income, such as interest, dividends and rental income earned in a reporting period; and

(b) capital gains and losses realized in sale and settlement transactions occurred in a reporting period.

.062 The unrealized gains and losses component of the investment return represents gains and losses from remeasuring the value of plan assets at the end of a reporting period. Such gains and losses may change in subsequent periods as plan assets are sold or settled, or the economic and market conditions change.

Expected and unexpected return

.063 An alternative view is that the investment return on plan assets is made up of an expected return component and an unexpected return component. This view facilitates:

(a) applying the same accounting for experience adjustments (difference between actual and expected/actuarial assumptions) in the plan assets side and the benefit obligation side; and

(b) reporting a net interest expense (which is defined as the expected return on plan assets net of the interest cost on the accrued benefit obligation) that represents the imputed financing cost of the benefit plan.

.064 As the interest cost is determined by applying the expected return on plan assets to the benefit obligation in funded or partially funded benefit plans, a net interest expense would be reported when the benefit obligation exceeds plan assets and vice versa. Those who support this view consider the expected return on plan assets as reflecting the time value of money in plan assets, similar to the interest cost reflecting the time value of money in the benefit obligation.

.065 Other employee benefits standards are essentially based on this view, regardless of whether and when actuarial gains and losses are recognized in annual surplus/deficit or profit/loss. However, others consider this view of dividing the investment return into expected and unexpected return components arbitrary and subjective because it is not based on the occurrence of an objective event or an economic transaction.

Recognition Alternatives for Components of Changes in the Accrued Benefit Obligation and Pension Assets

.066 One of the objectives of this Invitation to Comment is to seek stakeholders' views on how each component of the changes in the value of the accrued benefit obligation and plan assets should be recognized in the statement of operations (paragraphs .092-.114) and the statement of financial position (paragraphs .115-.128).

.067 Consideration of the nature of each component of the changes in the value of the accrued benefit obligation and plan assets, and the causes of changes in them, would be a logical starting point for such an evaluation. Other principles should also be considered (for example, the conceptual soundness of the recognition alternatives and the quality of the resulting financial information). The evaluation should take into account the public sector operating environment and the practicality of the overall solution.

.068 As discussed earlier (paragraphs .012-.013), recognition of the changes in the value of the accrued benefit obligation and plan assets in annual surplus/deficit in other employee benefits standards varies, depending on the financial reporting models in their respective conceptual frameworks.

.069 PSAB is undertaking a review of its conceptual framework. It has not yet determined if and how the current financial reporting model may change as a result of the review of its conceptual framework. PSAB's Conceptual Framework Task Force is examining the financial reporting model of other standard setters. Given that PSAB has not yet established a preliminary view on the financial reporting model, the recognition alternatives identified in this Invitation to Comment are not limited to those consistent with the existing financial reporting model.

Considerations in recognition of each component of the changes

.070 Determining the appropriate accounting for each component of the changes in the accrued benefit obligation and plan assets involve considering the following:

(a) the nature of each component of the changes and the causes of the changes;

(b) the conceptual soundness of the recognition alternatives;

(c) whether the resulting financial information can stand the test of time (including different economic, fiscal and funding circumstances);

(d) the operating environment in the public sector; and

(e) the practicality of the overall solution.

Nature of each component of the changes

.071 Actuarial gains and losses are recognized over a reasonable future period because of their tentative nature and because further adjustments will likely be required in the future. The earlier discussion (paragraphs .014-.065) suggests that not all components of the changes in the value of the accrued benefit obligation and plan assets subject to deferred recognition are of a tentative nature.

.072 Some components of the changes in the value of the accrued benefit obligation and plan assets will not be subject to further adjustments because they are caused by actual experience and transactions. Gains and losses realized in an individual investment in a plan asset portfolio in a reporting period would be an example. One may also argue that experience adjustments would fit into this category because, by definition, they reflect actual experience.

.073 Some components of the changes in the value of the accrued benefit obligation and plan assets, based on historical patterns, would likely be subject to further adjustments going in the same direction as previous adjustments. A change in the mortality assumption would be an example. Each set of mortality tables published by the actuarial profession in the last few decades has shown improvements from the previous one. Such changes are not tentative and further adjustments would likely be required in the future based on past experience.

.074 Further adjustments to some components of the changes in the value of the accrued benefit obligation and plan assets can possibly go in either direction. Previous adjustments can be offset or reversed by future adjustments. Unrealized gains and losses on plan assets would be an example. Such changes can be tentative and require further adjustments in the future.

Conceptual considerations

.075 Based on PSAB's financial reporting model, the statement of financial position should report liabilities and financial assets. The accrued benefit obligation, net of plan assets, if any, meets the definition of a liability. Plan assets, in excess of the accrued benefit obligation and valuation allowance for impairment, meet the definition of assets.

.076 Assets are defined as economic benefits controlled by a public sector entity as a result of past transactions or events and from which future economic benefits are expected to be obtained. Plan assets, in excess of the accrued benefit obligation and valuation allowance for impairment, represent the future economic benefit the entity expects to realize from a plan surplus and has access to at the financial statement date. The future economic benefit includes any withdrawable surplus or reduction in future contribution.

.077 Liabilities are defined as present obligations of an entity to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits. An accrued benefit obligation is defined as the value of benefits attributed to services rendered by employees and former employees to the financial statement date. The past event that gives rise to the accrued benefit obligation is the rendering of service by an employee. The entity has a responsibility to settle the obligation in the future by making benefit payment to the employee (directly or indirectly), for example, when he/she retires, reaches age 65 or becomes disabled, whichever is the relevant triggering event. A plan asset is defined as an asset segregated and restricted in a trust or other legal entity separate from the reporting entity to provide for benefits. Plan assets are to be used only to settle the related accrued benefit obligation. Any accrued benefit obligation in excess of plan assets set aside to settle the obligation would require future sacrifice of economic benefits by the entity for its settlement.

.078 Based on PSAB's financial reporting model, the statement of operations should report revenues and expenses, other than remeasurement gains and losses, of the accounting period. A change in the fair value of a financial instrument in the fair value category should be recognized in the statement of remeasurement gains and losses as a remeasurement gain or loss. Changes in the value of the accrued benefit obligation and plan assets meet the definitions of revenues and expenses.

.079 Revenues, including gains, are defined as increases in economic resources, by way of increases of assets or decreases of liabilities, resulting from the operations, transactions and events of the accounting period. They should be recognized in the period in which the transactions or events occurred that gave rise to the revenues. Gains are generally recognized when realized in the statement of operations.

.080 Expenses, including losses, are defined as decreases in economic resources, by way of decreases of assets or increases of liabilities, resulting from the operations, transactions and events of the accounting period. They should be recognized in the period in which the transactions or events occurred that gave rise to the expenses. Losses are generally recognized when realized in the statement of operations.

Different economic, fiscal and funding environments

.081 High-quality accounting standards should stand the test of time. They should provide relevant and reliable information throughout the changing economic conditions, fiscal environments and funding circumstances of a benefit plan. This is particularly relevant to an employment benefits standard. It is because benefit obligations are usually settled many years after an employee has rendered the services and over a long period of time.

.082 Though inflation and interest rates have been relatively low in recent years, they were double-digit rates a few decades ago. Similarly, many governments and benefit plans are in deficit positions in recent years. However, some governments and benefit plans have experienced surplus positions in the last few decades. A principles-based standard should faithfully represent the financial effects of employment benefits in good and bad years.

Public sector operating environment

.083 Some believe that the public sector operating environment is different from the private sector. In their view, determining the accounting for the changes in the accrued benefit obligation and plan assets should be considered in the context of the public sector operating environment.

.084 They argue that the presumption of perpetuity of governments and their power to tax suggest that public sector pension plans are less prone to solvency risk as would be the case in the private sector. They reason that it is less important to report all the changes in the accrued benefit obligation and plan assets as they arise in the financial statements of public sector entities. After all, accrued benefit obligations are settled over a long period and plan assets are invested for the long term.

.085 Others argue that public sector pension plans are not immune to sustainability and affordability considerations. They operate in the same economic and general environment as private sector pension plans, such as historic low interest rate, market volatility, increasing life expectancy and aging membership. They pointed to the evidence of governments filing for bankruptcy in the US, mainly contributed by pension deficits.

.086 Many public sector entities are subject to balanced budget legislation or requirements in a reporting period. Some argue that reflecting the volatility of the changes in the value of the accrued benefit obligation and plan assets in annual surplus/deficit as it arises could be a challenge for these entities. The volatility can put pressure on entities to make suboptimal decisions in good and bad times.

.087 Others argue that the volatility of the changes in the value of the accrued benefit obligation and plan assets reflects the risk related to the benefit promised by governments. Reporting the volatility as it arises would provide transparent and accountable information to users, even though some may be of a tentative nature. They argue that balanced budget legislation or requirements should not drive accounting, and the reporting of otherwise transparent and accountable information. Also, balanced budget legislation or requirements are not the same across jurisdictions.

.088 Budget is a key accountability document for senior governments. Budget to actual comparison is one of the key financial performance indicators in the public sector. Some argue that many components of the changes in the accrued benefit obligation and plan assets cannot be budgeted for or managed by a government in the short term. Given the relative size of benefit liability and expense in the financial statements of many public sector entities, the effect of changes in the value of the accrued benefit obligation and plan assets on the key financial measures can be significant.

.089 Others argue that entities may be able to directly or indirectly influence the investment and benefit provision decisions. Such decisions would affect the nature and extent of the volatility in the changes of the accrued benefit obligation and plan assets.

Practicality and implications

.090 One should consider if each component of the changes in the accrued benefit obligation and plan assets can be practically accounted for separately before determining the appropriate accounting for each component of the changes. For example, it may be difficult to account for the effect of a change in the inflation assumption separately because it is also a component of other economic assumptions. Separating realized and unrealized gains and losses may also be an issue for certain benefit plans.

.091 After determining the appropriate accounting for each component of the changes, one should consider whether the overall solution would be reasonable. For example, to what extent the different accounting for different components of the changes could add complexity to the overall understanding of the employment benefit liability and expense. Also, certain combinations of accounting treatments for different components may create opportunities for management of financial results. For example, treating changes in actuarial assumptions differently from experience adjustments may provide incentive in the selection of actuarial assumptions to achieve a particular accounting result.

Recognition alternatives in the statement of operations

.092 Each component of the changes in the value of the accrued benefit obligation and plan assets can be recognized in one of the following manners:

(a) Immediate recognition — recognize the change in the annual surplus/deficit as it arises (paragraphs .094-.098).

(b) No recognition — do not recognize the change in the annual surplus/deficit when it arises or in subsequent periods (no recycling) (paragraphs .099-.104).

(c) Deferred recognition — recognize the change in the annual surplus/deficit in subsequent period(s) (recycling) (paragraphs .105-.114).

.093 Depending on the financial reporting model that will be chosen by PSAB, a change in the value of the accrued benefit obligation and plan assets not recognized in the annual surplus/deficit when it arises ("no recognition" and "deferred recognition" alternatives) may be reported as an item in:

(a) the statement of financial position other than the net benefit liability/asset;

(b) the statement of operations (or equivalent statement) outside the annual surplus/deficit; or

(c) a statement other than the statement of financial position or the statement of operations.

Immediate recognition in the annual surplus/deficit

.094 Immediate recognition is conceptually sound because changes in the value of the accrued benefit obligation and plan assets meet the definitions of revenues and expenses. PSAB's current financial reporting model requires recognition of revenues and expenses in the statement of operations in the period in which the transactions or events that give rise to the revenues and expenses occurred.

.095 Actuarial assumptions are estimates of future events and factors. Experience adjustments and changes in actuarial assumptions represent adjustments to previous accounting estimates. Some argue that recognizing changes in actuarial assumptions and experience adjustments in the annual surplus/deficit when the changes and adjustments are made would be consistent with the accounting for changes in other accounting estimates in ACCOUNTING CHANGES, Section PS 2120.

.096 Measurement uncertainty and the use of actuarial assumptions are not unique to the estimate of accrued benefit obligations. Liabilities for contaminated sites and asset retirement obligations are also settled over a long period and subject to uncertain future events and factors. Changes to the estimate of these obligations may be triggered for example, by, changes in environmental standards, technological changes, changes to assumptions, experience gained and unforeseen changes in cost estimates. Changes in the estimates of these obligations are recognized in the period in which the revisions are made.

.097 Some argue that recognition of the changes in the value of the accrued benefit obligation and plan assets as they arise will result in the annual surplus/deficit reflecting the full cost (the cost of the benefit promised and the related financing cost) of the benefit promised to employees. Changes in actuarial assumptions and experience adjustments are part of the cost of the benefit promised. The interest cost on the accrued benefit obligation, net of the actual (not imputed or expected) investment return on plan assets, is the financing cost related to the benefit promised.

.098 Recognizing the changes in the value of the accrued benefit obligation and plan assets as they arise may result in volatility in the annual surplus/deficit. However, the statement of operations is meant to provide accountability information about an entity's operations. Some argue that since the volatility reveals the risk of the benefit promised, reflecting volatility in the financial results would provide transparent and accountable information to users of the financial statements.

No recognition in the annual surplus/deficit (no recycling)

.099 Some reason that not recognizing the changes in the value of the accrued benefit obligation and plan assets in the annual surplus/deficit at all provides a better solution compared to recognizing the changes when they arise (the "immediate recognition" alternative) or in subsequent periods (the deferred recognition alternative).

.100 Compared to the immediate recognition alternative, it removes the volatility caused by the changes in the value of the accrued benefit obligation and plan assets from the annual surplus/deficit. Information reflecting the risk of the benefit promised would still be provided in the financial statements.

.101 Some of the changes in the accrued benefit obligation and plan assets are of a tentative nature. They may be reversed or offset in subsequent periods and may never be realized. Some argue that reporting such changes as they arise can create unrealistic expectations that may put pressure on new spending in the good years, or lead to suboptimal decisions to cut spending in the bad years.

.102 Applying this alternative to all components of changes would mean that the budget to actual comparison would not be affected by the uncontrollable changes in the value of the accrued benefit obligation and plan assets. It also removes the uncertainty that may arise from changes in the value of the accrued benefit obligation and plan assets, which can affect the entity in meeting its balanced budget target.

.103 Compared to the deferred recognition or recycling alternative, the no recognition or no recycling alternative avoids the need for complex and arbitrary amortization of actuarial gains and losses.

.104 Some argue that the nature of the changes in the value of the accrued benefit obligation and plan assets that occur in a period does not change in subsequent periods. They should not be recognized one way when the changes occur and another way in subsequent periods. There is no reasonable basis to recycle or recognize the changes in subsequent periods.

Deferred recognition in the annual surplus/deficit (recycling)

.105 Some reason that recognizing the changes in the value of the accrued benefit obligation and plan assets in the annual surplus/deficit over an extended period would be a balanced approach.

.106 Never recognizing the changes in the annual surplus/deficit would diminish the meaning, accountability value and the usefulness of the annual surplus/deficit number. Over time, more changes would be accumulated outside the accumulated surplus/deficit. This would also dilute the accountability value and usefulness of the accumulated surplus/deficit number.

.107 Some argue that recognizing the changes in the value of the accrued benefit obligation and plan assets over an extended period would better reflect the long settlement period of the accrued benefit obligation and the long-term investment horizon of plan assets.

.108 Recognizing the changes in the value of the accrued benefit obligation and plan assets over an extended period may not completely remove volatility related to the changes in the annual surplus/deficit. However, some argue that it would smooth out the effect of these changes and allow short-term fluctuations to be offset. This could lessen the pressure on entities to take suboptimal actions based on tentative changes that may never be realized to meet their balanced budget target.

.109 Recognizing the changes in the value of the accrued benefit obligation and plan assets over an extended period would also allow the budgeting process to incorporate future amortization of the changes in subsequent periods.

Amortization options

.110 Section PS 3250 requires recognition of actuarial gains and losses over the expected average remaining service life of the related employee group in a systematic and rational manner, with the exception of those related to plan amendments occurring in the period under certain circumstances.

.111 Some consider the expected average remaining service life of the related employee group an appropriate amortization period for actuarial gains and losses because they are related to services already rendered. Recognizing actuarial gains and losses over the remaining service life of the related employee group would be logical. Others indicate that applying this amortization period to benefit plans that are closed to new members would mean a shorter amortization period or immediate recognition. They argue that an expected average settlement period may be a more relevant amortization period for closed plans as it may take decades for these plans to fully settle the obligation.

.112 Some consider the expected average remaining service life of the related employee group too long for amortization of actuarial gains and losses in most benefit plans. It is because it could hide the effects of investment risk-taking and the risks related to the benefit promised. The GASB standard requires amortization of the unexpected return on plan assets over five years because it represents the general market cycle. Some argue that this amortization period would be consistent with the rationale for deferred recognition of the investment return in the first place.

.113 Others argue that unrealized gains and losses on plan assets are of a similar nature as a change in the fair value of financial instruments and, therefore, should be accounted for consistently. This would mean that unrealized gains and losses would be recognized in the annual surplus/deficit when the asset is sold or settled. Recognition of deferred gains and losses in the annual surplus/deficit based on an observable transaction would be objective.

.114 However, some question if this would be practical because the transactional information about individual holdings may be held outside the entity, and kept by the pension board or an investment entity. It may also depend on the volume of the sale and settlement transactions involved, and the quantity of investments held in certain plans.

Recognition alternatives in the statement of financial position

.115 Under the deferral provisions in Section PS 3250, the net benefit liability/asset has three components:

(a) accrued benefit obligation;

(b) plan assets, if any; and

(c) unamortized actuarial gains and losses.

.116 As discussed earlier (paragraph .011 and Chart 1), the net benefit liability/asset in other employee benefits standards is the accrued benefit obligation determined in an actuarial valuation, net of plan assets valued at fair value, and any valuation allowance required for a net benefit asset. There is no adjustment for unamortized actuarial gains and losses.

.117 If all changes in the value of the accrued benefit obligation and plan assets are recognized in the annual surplus/deficit when they arise (the immediate recognition alternative), or will never be recognized in the annual surplus/deficit (the no recognition alternative), there would be no need to recognize any unamortized actuarial gains and losses.

.118 Determining if an adjustment for any unamortized actuarial gains and losses should be made in the net benefit liability/asset number reported in the statement of financial position would be needed when some or all of the changes in the value of the accrued benefit obligation and plan assets are recognized in the annual surplus/deficit in subsequent periods (the deferred recognition alternative).

Adjustment for unamortized changes in the accrued benefit obligation and plan assets

.119 Some may reason that the unamortized changes in the value of the accrued benefit obligation and plan assets (unamortized changes) should be part of the net benefit liability/asset because it is the status quo. It would be familiar to users of financial statements. There would be no need to find a spot to report the unamortized changes in the financial statements.

.120 Some may argue that a net benefit liability/asset without an adjustment for unamortized changes would provide a more understandable and faithful representation of the financial position of the plan. It would reflect the best estimate of the value of the accrued benefit obligation and plan assets (if valued at fair value) at the financial statement date. This would also avoid the risk of reporting a misleading net benefit liability/asset number. For example, reporting a net benefit asset when the accrued benefit obligation exceeds plan assets because of the unamortized changes.

Valuation Alternatives for Plan Assets

.121 Section PS 3250 requires plan assets to be valued at market-related values. Since market-related value is defined as market value or a value that is adjusted to market value over a period not to exceed five years, it effectively allows plan assets to be valued at market values or a smoothed market value. A valuation alternative would be to remove the options and require plan assets to be measured at market value.

Market value only

.122 Measuring plan assets at their market values most faithfully represents the best estimate of the assets set aside for meeting the accrued benefit obligation at the financial statement date.

.123 Valuing plan assets at their market values would be consistent with how plan assets are measured in the benefit plan's own financial statements in accordance with accounting standards for pension plans in Part IV of the CPA Canada Handbook – Accounting. This will avoid having two sets of plan asset numbers reported in the financial statements of the employer/sponsor and the benefit plan itself.

.124 The concept of fair value measurement would be familiar to many users of financial statements. Guidance on fair value measurement is provided in the International Financial Reporting Standards in Part I of the CPA Canada Handbook – Accounting.[8]

.125 Valuing plan assets at market values is also consistent with how other financial assets that are managed on a fair value basis are often valued in accordance with FINANCIAL INSTRUMENTS, Section PS 3450. It would provide transparent and easy-to-understand information, and enhance comparability between public sector entities.

Market-related value

.126 Section PS 3250 states that the reason for valuing plan assets at their market-related values is to minimize short-term fluctuations. The use of market-related value would allow the fluctuations to be reversed and offset within a typical economic or market cycle.

.127 Section PS 3250 also states that market-related values closely approximate current economic value, and are objective and verifiable. One may argue that since plan assets are invested for the long term, market-related value would be a close approximate of the current economic value of plan assets.

.128 However, others may argue that market-related value is an actuarial basis of measurement. It is not referred to in accounting literature as a measurement basis for assets. Some argue that the use of market-related value to measure plan assets is essentially an “off-book” deferral mechanism. It may mislead users of financial statements because they may not be aware of the difference between market value and market-related value.

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[8] IFRS 13 *Fair Value Measurement*.