Analysis

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International Financial Reporting Standards: Canada adopting new global accounting standards

Canada will adopt the International Financial Reporting Standards (IFRSs) effective January 1, 2011. This *Analysis* gives you some background and comparison on what changes you can expect.

Specifically, it outlines:

- what organizations will be affected by the changes,
- the differences in accounting for pensions and other post-employment benefits between the current Canadian and international standards, and
- the transition options.

Will they be relevant to your organization?

The Canadian Accounting Standards Board (AcSB) has announced that all **publicly accountable enterprises** will move to the International Financial Reporting Standards for fiscal years beginning on or after January 1, 2011.

For organizations that are not publicly accountable enterprises, the AcSB has approved a new set of accounting standards for **private enterprises** in Canada. These largely follow the current Canadian Institute of Chartered Accountants (CICA) standards. Private enterprises will have the option to adopt these new "made-in-Canada" standards as early as 2009, or adopt IFRSs on January 1, 2011.

For **not-for-profit organizations**, a review is currently being undertaken to determine the future standards to be applied. The existing standards will remain in place for the time being, and a later effective date than January 1, 2011 is anticipated to be applied for any future changes.

The Public Sector Accounting Board confirmed in October that **government business enterprises** will be required to follow International Financial Reporting Standards (IFRSs) for periods beginning January 1, 2011. A government business enterprise is a separate legal entity controlled by government that has the authority to conduct business, sell goods and services outside of government, and is self-sustaining from those sales. Other government organizations will continue to follow existing standards until a review of the future standards is complete.

A **publicly accountable enterprise** is an entity, other than a not-for-profit, government organization or other entity in the public sector, that:

(a) has issued, or is in the process of issuing, debt or equity instruments that are, or will be, outstanding and traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets); or

(b) holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

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What do all these acronyms mean?

Get ready to add **IASB**, **IAS**, **IFRS** and **IFRIC** to your growing vocabulary of acronyms.

Acronym	Full name	Background
IASC	International Accounting Standards Committee	Formed in 1973.
IASB	International Accounting Standards Board	Formed in 2001. Replaced the IASC.
IASs	International Accounting Standards	Standards issued by the IASC, and adopted by the IASB.
IFRSs	International Financial Reporting Standards	Standards issued by the IASB.
IFRIC	International Financial Reporting Interpretations Committee	Interpretations of IASs and IFRSs.

The goal of the IASB is to develop a single set of high-quality, understandable and enforceable accounting standards to help participants in the world's capital markets and other users make economic decisions.

The relevant pension accounting standard, the compatriot of **CICA 3461** is **IAS 19 – Employee Benefits**. There are currently only eight IFRSs. The most relevant of these for pension purposes is **IFRS 1**, which deals with initial adoption of the IASs and IFRSs. Also of particular interest to pension plans is **IFRIC 14 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction**. Compliance with the interpretations issued by IFRIC is mandatory.

Since 2001, more than 100 countries have required or permitted reporting under IFRS.

Canadian public entities will be required to adopt all IFRSs, with the exception of IAS 26 - Accounting and Reporting by Retirement Benefit Plans. The AcSB is proposing to keep in place an amended CICA 4100, *Pension Plans*, in place of adopting IAS 26.

How does IAS 19 compare to CICA 3461?

The IAS and CICA standards are built on the same framework and are substantially the same. Of course there are some differences, which we look at in detail as follows:

Short-term employee benefits

CICA 3461 doesn't apply to benefits provided to employees during their active service. IAS 19, on the other hand, includes benefits (in addition to termination benefits, which are addressed separately below), that fall wholly due within 12 months after the end of the period in which the employees render related service. Examples include salaries, paid vacation time, paid sick leave, profit sharing and bonuses.

Under CICA 3461, profit sharing and bonuses would generally be recognized as expenses in the period during which the service was rendered. Under IAS 19, short-term employee benefits are recognized as an expense in the period the employee provides the services, and a liability is recognized for any unpaid short-term benefits. The obligations are measured on an undiscounted basis.

Defined contribution plans

IAS 19 and CICA 3461 are mostly aligned for defined contribution plans. Areas of difference include:

- past service costs, which aren't addressed under IAS 19; and
- the disclosure requirements, which are currently more extensive under CICA 3461.

IAS 19 also includes a broader definition of a defined contribution plan than CICA 3461. Under IAS 19, a defined contribution plan is one under which an entity pays fixed contributions and has no obligation to pay further contributions if the fund does not have enough assets to pay the employee benefits in respect of past service (i.e., the entity's legal or constructive obligation is limited to the amount it agrees to contribute to the fund).

Under CICA 3461, a defined contribution plan is a plan that specifies how an entity's contributions to the plan are determined, rather than the benefits to be received. However, the definition goes on to say that a defined contribution plan is one that allocates the entity's contributions to specific individuals.

Multi-employer plans

IAS 19 does include reference to multi-employer plans, and requires the reporting entity to classify them as either a defined benefit multi-employer plan or a defined contribution multi-employer plan. Under the IAS definition of a defined contribution plan, many defined benefit multi-employer plans in Canada would be classified as defined contribution plans and would therefore be subject to defined contribution accounting. Exceptions to this would occur where the reporting entity has an obligation, under the plan's terms or pension legislation, to pay further contributions if the fund does not have enough assets to pay the employee benefits in respect of past service. In this case, the plan would be classified as a defined benefit multi-employer plan.

If a plan is classified as a defined benefit multi-employer plan, the entity is required to account in the same manner as for other defined benefit plans, unless sufficient information is not available to apply defined benefit accounting, in which case defined contribution accounting can be used. In that case, the entity is also required to disclose:

- that the plan is a defined benefit plan and the reasons why sufficient information is not available to account on a defined benefit basis; and
- to the extent that a plan surplus or deficit may affect future contributions, any information available about the surplus or deficit and any implications for the entity.

Although the definition of a defined contribution plan under CICA 3461 would generally not apply to defined benefit multi-employer plans, CICA 3461 also permits multi-employer plans to be accounted for as defined contribution plans, unless sufficient information is available to apply the requirements for defined benefit plans.

Defined benefit pension plans

Actuarial gains and losses

IAS 19 currently permits the 10% corridor approach as allowed under CICA 3461 when recognizing gains and losses. Under IAS 19, the maximum amortization period is the average remaining service period of participating employees, regardless of whether the majority of participants are active or inactive.

Under CICA 3461, the period used is the average remaining service period for active employees only. If most or all of the employees are no longer active, the average remaining life expectancy of the inactive participants is used.

For inactive plans, this may result in a significant difference under IAS 19. In the absence of any remaining service period, actuarial gains and losses above the corridor may need to be recognized immediately when they occur.

Both IAS 19 and CICA 3461 permit an entity to recognize actuarial gains and losses in any systematic way that results in a faster recognition than the 10% corridor approach. Such an approach is permitted, provided the same basis is applied to both gains and losses, and is applied consistently from period to period and plan to plan.

In addition, IAS 19 also permits an entity to recognize gains and losses immediately in the year they occur through equity via other comprehensive income (rather than through profit and loss). If this approach is adopted, it must be adopted for all defined benefit plans sponsored by the entity and for all actuarial gains and losses. Actuarial gains and losses recognized in other comprehensive income are recognized immediately in retained earnings and are not reclassified to profit and loss in a subsequent period.

In summary, there are currently four options available for recognizing actuarial gains and losses under IAS 19. These include recognizing gains and losses:

(1) using the 10% corridor approach in profit and loss with amortization of any excess over the average remaining service period of participating employees; or

(2) in a systematic way that results in faster recognition than the 10% corridor approach in profit and loss; or

(3) immediately in profit and loss; or

(4) immediately in other comprehensive income.

An *exposure draft* of amendments to IAS 19 is expected early in 2010. This will likely require the immediate recognition of actuarial gains and losses, either in profit and loss each year or through other comprehensive income.

Recognition through profit and loss will make it impossible to prepare estimates of expense for future years. Therefore, it is likely that most plan sponsors will opt to use immediate recognitions through other comprehensive income in order to reduce volatility in the expense and make future estimates more predictable.

Past service costs

The recognition of past service costs represents a major difference between IAS 19 and CICA 3461. Under the latter, past service costs are amortized over the average period up to full eligibility for each active employee at the amendment date who were not fully eligible for benefits. In the case where most or all of the employees are no longer active, past service costs under CICA 3461 are amortized on a straight-line basis over the average remaining life expectancy of the inactive participants.

Under IAS 19, past service costs must be recognized in expense on a straight line basis over the average period until they vest, where vested benefits are those that are not conditional on future employment. So, if you have a plan amendment that provides a benefit improvement that applies to all plan members as of the date of the amendment, you must recognize the entire cost of the improvement in expense in the fiscal year the improvement is made for all vested benefits. As a result, this could lead to a significant increase in pension expense in the year of a benefit improvement. In comparison, under CICA 3461, the pension expense would show a more modest increase, recognized over a longer period of time.

What if you have a plan amendment that does not vest immediately, such as under a negotiated labour contract where the increased benefit applies over multiple years? Typically, a member is only entitled to the increased benefit rate if he or she continues to be an actively accruing member as of the date of increase. In this case, the total cost of the benefit increase would be spread over the period to the last negotiated increase.

Expected return on plan assets

Under CICA 3461, the expected return on assets can be calculated based on the market value of assets, or a market-related value. Under IAS 19, only the market value can be used. The impact of this change is not expected to be significant on pension expense, unless the difference between fair and market-related assets is significant.

IAS 19 specifies that expected administration costs charged to the fund should be deducted when determining the expected and actual returns on plan assets, other than those provided for in the actuarial assumptions used to measure the obligation.

Measurement date

CICA 3461 permits the use of a measurement date up to three months before the date of the financial statements. Under IAS 19, the present value of the liabilities and assets must be determined at the balance sheet date. This means a plan sponsor cannot finalize the obligation until the discount rate and the market value of assets in effect at the balance sheet date is known.

Limit on the accrued benefit asset

Although both standards limit the amount of accrued benefit asset that a plan sponsor may recognize, the two standards differ in the calculation and application of the limit. In addition, IFRIC 14 also applies under IFRS, which could further limit the accrued benefit asset. IFRIC 14 contains the requirement to include the impact of a minimum funding requirement when calculating the limit on the accrued benefit asset. A minimum funding requirement (MFR) is “any requirement to fund a post-employment or other long-term defined benefit plan.” The interpretation of what constitutes an MFR for Canadian pension plans is under great debate, the outcome of which may have a significant impact on plan sponsors.

Entities with two or more plans

CICA 3461 permits entities with two or more plans to aggregate the unfunded plans for measurement and disclosure purposes under certain circumstances. IAS 19 requires separate accounting for each material plan, although separate disclosures are not required.

Settlements and curtailments

A settlement is an event which relieves an entity of providing benefits. Under a settlement, employees can continue to earn benefits by providing future service. An example is where an entity makes a lump-sum cash payment to employees in lieu of providing past service benefits.

A curtailment is an event which results in a material reduction in the number of employees entitled to receive benefits under the plan, or a material reduction in the expected years of future service of the active employees. Under a curtailment, employees are no longer able to earn benefits by providing future service. Examples of curtailments include the closure of a plant or the termination of a plan.

Settlements are recognized under both CICA 3461 and IAS 19 when they occur. Although there are some differences between the two standards relating to the treatment of transitional obligations and past service costs, the differences are unlikely to have a significant impact on Canadian plans.

Curtailment gains may be recognized sooner under IAS 19 than under CICA 3461. The curtailment cost under the two standards is also likely to differ, due to the different treatment of unamortized actuarial gains and losses.

Additional ongoing disclosure requirements

IAS 19 includes the following disclosure requirements for defined benefit plans that are in addition to those required under CICA 3461:

- An analysis of the defined benefit obligation into amounts arising from plans that are wholly unfunded and amounts arising from plans that are partially or fully funded.
- Amounts as follows for the current annual period and preceding four annual periods (or later date of transition to IFRSs):
  - The present value of the defined benefit obligation, the fair value of assets and the surplus or deficit in the plan;
  - The experience adjustments arising on plan liabilities expressed as either an amount or as a percentage of plan liabilities at the end of the reporting period; and
  - The experience adjustments arising on plan assets expressed as either an amount or as a percentage of plan assets at the end of the reporting period.
- The employer's best estimate of contributions expected to be paid to the plan during the annual period following the end of the reporting period.

Other long-term employee benefits

These are benefits, other than post-employment and termination benefits, that do not fall due wholly within 12 months after the end of the period the employee renders the related service. Examples include compensated long service absences or sabbaticals, long service benefits and long term disability benefits.

Under IAS 19, any actuarial gains or losses and past service costs associated with these benefits are recognized immediately, and no corridor is applied for the former. Under CICA 3461, delayed or immediate recognition is permitted, provided it is applied consistently from year to year.

Termination benefits

These are benefits payable when an entity terminates an employee prior to normal retirement age, or an employee voluntarily accepts redundancy. They are typically lump-sum payments. However, they may also include, for example, an enhancement to the retirement benefits otherwise payable, either directly through a pension plan, or indirectly, or salary payable to the end of a notice period during which the employee is not rendering further service.

Under CICA 3461, contractual termination benefits are recognized as an expense and a liability when it is probable that the employees will be entitled to the benefits, and the amount can reasonably be estimated. Special termination benefits, classified as those provided on voluntary or involuntary termination, are recognized as an expense and a liability when management approves and commits to the termination plan.

IAS 19 does not distinguish between contractual and special termination benefits. All termination benefits are recognized as an expense and a liability when the entity is demonstrably committed to the termination. This is generally defined as when the entity has a detailed formal plan in place that does not have a realistic possibility of withdrawal.

As a result, there may be some difference in the timing of recognizing termination benefits under CICA 3461 and IAS 19.

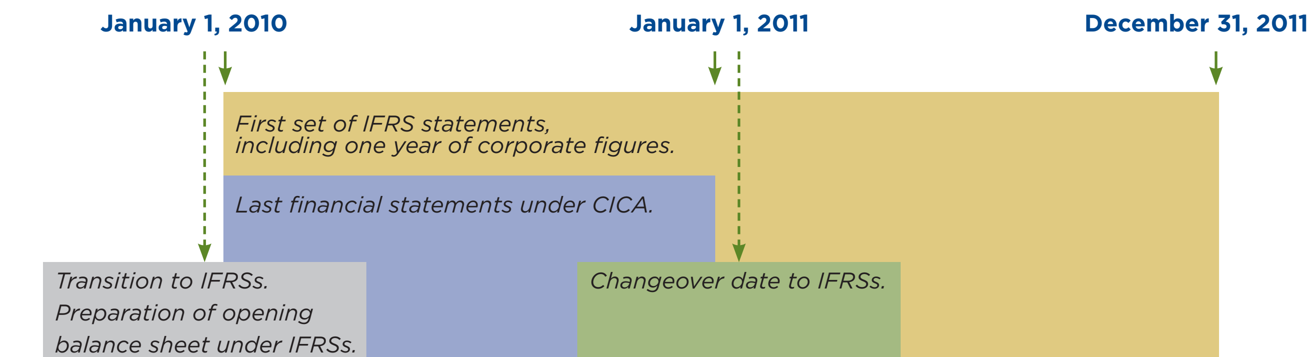
Initial adoption and IFRS 1

IFRS 1, *First-time Adoption of International Financial Reporting Standards*, covers first-time adoption of the IFRSs.

As mentioned above, Canadian publicly accountable enterprises are required to adopt IFRSs for interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011. On adoption, at least one year of comparative information under IFRS is required.

For illustrative purposes, let's explore ABC Ltd., which has a calendar year end. ABC Ltd. will adopt IFRS as of January 1, 2011, however, it will require one year of comparative information under IFRS for the year ending December 31, 2010. It will therefore have to prepare an opening balance sheet under IFRS as of January 1, 2010, the transition date to IFRS.

Timeline



Opening balance sheet

Under IFRS 1, the general principle is that an entity applies IFRSs on a retrospective basis (i.e., as if the IFRS standards had always applied to the financial statements of the entity). The IASB does recognize that this approach could increase cost and complexity of first-time adoption, and it has established various exemptions in areas where retroactive application would be impractical. The only area relevant to IAS 19, where a retroactive application exists, is in the treatment of unamortized actuarial gains and losses.

Unamortized actuarial gains and losses

For unamortized actuarial gains and losses, there are two possible options on adoption:

1. **Retrospective approach** – an entity retrospectively applies IAS 19 to all previous accounting periods to split the cumulative actuarial gains and losses into a recognized and unrecognized portion as of the date of transition. The unrecognized portion can continue to be amortized going forward (under the approach adopted under IAS 19).

or

2. **IFRS 1 exemption** – a first-time adopter can elect to recognize all cumulative actuarial gains and losses at the date of transition to IFRS, even if it uses the corridor approach to amortize future actuarial gains and losses. If a first-time adopter uses this election, it must apply it to all plans.

In Canada, it is likely that most companies will adopt option 2.

Unamortized past service costs

There is no exemption to retrospective application of IFRSs for unamortized past service costs, but the treatment merits an explanation. Based on a retrospective approach, any unamortized past service costs should be split into a vested and unvested portion, if any. Only the unvested portion will remain at transition, and will be amortized under IAS 19 over the period until vesting. The vested portion is assumed to have been previously recognized in expense, as would have been the case if IFRSs applied in the past, and must be recognized immediately at the date of transition through retained earnings.

Differences in the opening balance sheet between CICA 3461 and IAS 19 are recognized in retained earnings.

Standards for the opening balance sheet

The initial IFRS financial statements and comparative figures must be prepared using the IFRSs effective at the end of the year of initial adoption. For example, ABC Ltd. must use the IFRSs in effect as at December 31, 2011, for the initial and comparative figures.

As of the publication date of this *Analysis*, some amendments are expected to IAS 19 that may be effective prior to January 1, 2012. The IASB is currently reviewing IAS 19, and is anticipating releasing an *Exposure Draft* of changes in the first quarter of 2010 with expected implementation dates ranging from 2011 to 2013. One of the most significant changes expected is the requirement to immediately recognize all actuarial gains and losses in the period during which they occur. This will have a significant impact on Canadian entities, as most will be accustomed to amortizing gains and losses, and utilizing the corridor method. Immediate recognition will lead to significantly increased volatility in plan expenses, unless the recognition through other comprehensive income is used.

Disclosure requirements on initial adoption

An entity's first financial statements following adoption of IFRSs shall include the following:

(a) reconciliations of its equity reported in accordance with CICA standards to its equity in accordance with IFRSs for both of the following dates:

- (i) the date of transition to IFRSs, and
- (ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with CICA standards.

and

(b) a reconciliation to its total comprehensive income in accordance with IFRSs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with CICA standards for the same period or, if an entity did not report such a total, profit or loss under CICA standards.

On transition under IFRS, ABC Ltd., for example, will need to present:

- three statements of financial position (as of January 1, 2010, December 31, 2010 and December 31, 2011);
- two statements of comprehensive income;
- two separate income statements (if presented);
- two statements of cash flows; and
- two statements of changes in equity and related notes, including comparative information (all as of January 1, 2010 and December 31, 2010).

The requirement to prepare the first interim financial statements under IFRS will be March 31, 2011 for an entity that has a calendar year end. At this point, most of the disclosures noted above under the annual requirement will be needed for the interim period, including the reconciliations to previous GAAP. Entities impacted by IFRS should start preparing figures under IFRS as of the transition date to ensure they are able to meet the required disclosures in a timely manner.

If you have any questions on how IFRS will impact you, please contact your Eckler consultant.

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