Memorandum

To: Our Clients

From: Actuarial Department

Date: January 8, 2016

Re: New Accounting Development – Alternative Discount Rate Approaches

Introduction

We would like to provide you with a brief update on an area of emerging practice. In particular, we wish to alert you to the fact that alternative approaches for applying discount rates in the pension (and post-retirement health benefit plan) expense calculations are being considered by entities, their actuaries, and their accountants.

We wish to remind you that we are not public accountants and this memo is for informational purposes. Should you wish to consider changes in your accounting policies we recommend that you discuss this opportunity with your audit firm.

Background

Currently, most entities that sponsor a defined benefit pension or post-retirement benefit plan use an 'aggregated approach' when establishing and applying the discount rate. It is our understanding that some alternative discount rate approaches are considered to be "more precise", and may provide 'more favourable' results. It is also our understanding that several (but not yet a majority of) entities have adopted one of these alternative discount rate approaches.

This memo will be of particular interest to our clients who prepare accounting results under IFRS, US GAAP, or ASPE (and who have adopted an accounting valuation approach within ASPE, as opposed to a going-concern funding valuation approach).

The remainder of this memo provides a brief discussion on this emerging practice.

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Discount Rate Approaches

Aggregated Approach

The traditional method to developing the discount rate is an aggregated approach as follows:

i) obtain the projected cash flows for the benefit obligations of a plan;

ii) calculate the present value of those cash flows using the spot rates derived from a yield curve developed using high quality corporate bonds; and

iii) solve for the single discount rate which results in the same present value produced in step ii.

Using this approach, the discount rate could be viewed as a weighted average of the yield curve spot rates. Once calculated, this single discount rate is used in calculating the service cost and interest cost components of the pension expense.

Spot Rate Approach

The main alternative approach that is emerging in practice is the use of the "spot rate approach". Under this approach, the benefit obligations are determined by applying steps i and ii above resulting in the same benefit obligations calculated using the aggregated approach. However, in contrast to the aggregated approach, the service cost and interest components of the pension expense are calculated differently under the spot rate approach.

Under the spot rate approach, the service cost is calculated using a similar manner as that used to determine the benefit obligations, but using different cash flows. Specifically, one would obtain the projected cash flows for the service cost of a plan, and then calculate the present value of those service cost cash flows using the spot rates derived from the corporate bond yield curve.

Under the spot rate approach, the interest cost is determined by multiplying, for each future year, the discounted benefit obligation cash flow by the duration-specific spot rate derived from the corporate bond yield curve.

Observations

As stated above, the benefit obligations at any fiscal year-end are expected to be the same under both the aggregated approach and the spot rate approach. However, in a normal economic environment where there is an upward-sloping yield curve, the spot rate approach will usually produce lower service cost and lower interest cost expense components, but will also produce an offsetting actuarial loss to be recognized in other comprehensive income (or amortized in future years for entities that report under US GAAP and have an accounting policy to defer actuarial gains and losses).

For entities that report under IFRS, ASPE, or US GAAP with an accounting policy to immediately recognize actuarial gains and losses, the alternative approach generally reallocates components of the pension expense to different line items in the income statement (i.e. a reshuffling of the results within the pension expense and other comprehensive income), but with no net impact on the overall results in a given year.

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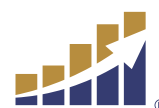

However, for entities that report under US GAAP and have an accounting policy to defer actuarial gains and losses, we note that the alternative discount rate approach will have an impact on the pension expense in a given year which may or may not be material. Again, generally (when the yield curve is upward sloping) the spot rate approach produces lower service costs and lower interest costs, but will lead to increased actuarial losses as compared to the aggregated approach. This may have the affect to produce lower pension expenses in the near term, and lead to a higher pension expense in the future.

It is our understanding that the spot rate approach has been accepted by the U.S. Security and Exchange Commission (SEC). Further, the SEC has indicated that a change to this approach should likely be treated as a change in accounting estimate, and that they would expect that an entity would not change back to the aggregate approach after the spot rate approach has been adopted.

For many of our clients, we expect that there will be a preference to maintain the aggregated approach. This decision may be driven by the lack of overall materiality to their pension accounting results between the two methods, the simplicity of the aggregated approach, or the fact that the spot rate approach is not yet widely accepted.

However, some of our clients may wish to explore this option further, especially if the pension accounting results are significant drivers in their financial statements, and/or they are trying to maintain certain capital requirements or financial metrics. For clients that do wish to explore this option further, we wish to note the following:

- While this approach is considered "more precise", it is also more complex. A transition to this approach would result in additional time and effort by the plan actuary as well as management and their auditor
- A transition to the spot rate approach would ideally be adopted at a fiscal year-end (e.g. December 31, 2015), and applied to the expense in the following period (e.g. the FY2016 expense).
- While it is our understanding that the spot rate approach could be adopted on a prospective basis (without the need to restate the accounting entries for prior years), we also understand that there may be the need to provide additional financial disclosures surrounding the impact of the change.
- An entity with multiple benefit plans will need to consider whether to adopt the spot rate approach for all of its plans, or a subset of its plans.

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As noted at the outset of this memo, we wish to remind you that we are not public accountants and this memo is for informational purposes. Should you wish to consider changes in your accounting policies we recommend that you discuss this opportunity with your audit firm.

Please feel free to contact your consultant (Jason, Dean, or Carly) if you would like to discuss this matter further.

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