Limit on the Carrying Amount of an Accrued Benefit Asset

Foreword to **Question 89.1** The AcSB staff has received inquiries from accountants and actuaries about an issue arising from the application of EMPLOYEE FUTURE BENEFITS, Section 3461 of the *CICA Handbook – Accounting*. This issue relates to a change in the valuation allowance against the carrying amount of an accrued benefit asset.

This commentary describes the circumstances as well as the issue, and makes an observation. The guidance provided under "Answer" describes the only possible answer. Other outcomes would not be in accordance with Section 3461.

89.1 **When an entity has net unamortized actuarial losses with a policy of deferral and amortization of these losses, is it appropriate to record a credit to income as a result of a decrease in the amount of a valuation allowance pertaining to the limit on the carrying amount of an accrued benefit asset for a defined benefit pension plan? Does a problem also arise in the reverse situation with net unamortized actuarial gains?**

Circumstances The downturn in the stock market in 2001 has resulted in some entities with defined benefit pension plans experiencing significant actuarial losses that have substantially eroded or eliminated a previously accumulated plan surplus. In addition, the general decline in interest rates also has triggered a similar result since entities have discounted the accrued benefit obligation at a lower rate than in the prior year, resulting in an actuarial loss. Some of these entities may also have recorded a valuation allowance against the carrying amount of an accrued benefit asset in previous years (see *Handbook* paragraphs 3461.101 – .110).

In following the guidance in Section 3461, an entity records a charge or credit to income for the period in which the valuation allowance changes. Under Section 3461, the treatment of actuarial losses depends on the accounting policy adopted. An entity with a defined benefit plan may recognize actuarial gains and losses in income immediately or defer them, subject to a minimum amortization requirement for accumulated amounts outside a defined "corridor".

Some entities with a defined benefit plan may find that they have recognized a credit to income from reversing a valuation allowance against an accrued benefit asset and a relatively smaller charge to income from amortizing actuarial losses on plan assets. The overall effect is to recognize a net credit to income in a year in which a plan's financial position has deteriorated substantially.

Answer A numerical example following *Handbook* paragraph 3461.110 illustrates these circumstances. A credit to income resulting from a decrease in the valuation allowance that occurs during a period of actuarial losses in pension plan assets, even significant actuarial losses, is consistent with Section 3461. An entity with a policy of deferring and amortizing actuarial gains and losses (rather than one of recognizing them in income immediately) may not have amortized sufficient net actuarial losses to the income statement to offset the effects of decreasing the valuation allowance.

The cumulative effects of profits and losses reflected in income as a result of fluctuations in the valuation allowance make most sense when viewed over a period of years. For example, a decrease in the valuation allowance offsets or reverses recognized higher charges to earnings in prior years and gets an entity back in the position it would have been if it had never recorded a valuation allowance in the first place. An entity would have recognized the amount of the valuation allowance reversal in income over time in the normal course of pension accounting rather than in a lump sum as it does when the valuation allowance changes.

Alternatively, an entity may consider changing its accounting policy from a policy of deferral and amortization of actuarial gains and losses to immediate income recognition (see *Handbook* paragraphs 3461.087 – .088 as well as *Employee Future Benefits Implementation Guide* Q&A 83). In such circumstances, entities should follow the Recommendations of ACCOUNTING CHANGES, Section 1506 of the *CICA Handbook – Accounting*. In addition, it would be inappropriate for an entity to change its accounting policy subsequently to deferral and amortization since if the first change complied with the guidance described in paragraph 1506.02, the second change could not. Entities may wish to consider that immediate income recognition would likely result in more volatility in earnings in future years even though it may mitigate the issue in the current year.

Entities should adopt a method of recognizing actuarial gains and losses in income in accordance with paragraph 3461.087, on the following basis:

- The method adopted has to be "systematic". A systematic method of amortization cannot include an override based on what the effect on earnings would be if the normal system of amortization produces an expense that some think is too low in a particular year.
- The method has to be "applied consistently to both gains and losses".

An entity should follow the guidance within *Limit on the carrying amount of an accrued benefit asset,* paragraphs 3461.101 – .110, while adhering to the guidance in *Actuarial gains and losses,* paragraphs 3461.087 – .093. Specifically, paragraph 3461.090 has no provision for modifying the determination of an actuarial gain or loss on plan assets when an entity recognizes a valuation allowance.

When an entity determines the expected return on plan assets "using a market-related value, the actuarial gain or loss on plan assets includes both:

(a) amounts reflected in the market-related value of plan assets (i.e., that portion of the preceding periods' actuarial gain or loss on plan assets that has been incorporated in the market-related value); and

(b) amounts not yet reflected in the market-related value of plan assets (i.e., the effects of changes in the fair value of plan assets not yet amortized into the market-related value).

An actuarial gain or loss not yet reflected in the market-related value of plan assets (i.e., item (b) above) is not required to be amortized in accordance with paragraphs 3461.087 – .088. That part of the actuarial gain or loss is amortized when it is included in the market-related value of plan assets over future periods.”

Therefore, the market-related value adjustment (item (b)) is required to be included in the determination of an actuarial gain or loss on plan assets.

This approach is entirely consistent with Canadian generally accepted accounting principles, which do not generally support a basis for deferring and amortizing the effect of adjusting an asset valuation account. Although pension accounting generally supports the deferral and amortization of certain gains and losses, the AcSB did not intend the valuation allowance to operate in such a manner.

The reverse situation of net unamortized actuarial gains and an increase in the valuation allowance resulting in a charge to the income statement is also consistent with Section 3461. An entity with a policy of deferring and amortizing actuarial gains and losses may not have amortized sufficient net actuarial gains to the income statement to offset the effects of increasing the valuation allowance. Year 2 in the numerical example that follows *Handbook* paragraph 3461.110 illustrates these circumstances.