

2013 SURVEY

**Economic Assumptions in Accounting for
Pension and Other Post-Retirement Benefits**

Highlights of our Annual Survey Results

In this report, Morneau Shepell is pleased to provide information on the assumptions being used by approximately 100 Canadian public companies to account for the costs of their defined benefit plans. Information is based on audited financial statements as at December 31, 2012. This is the thirteenth year that the survey has been produced.

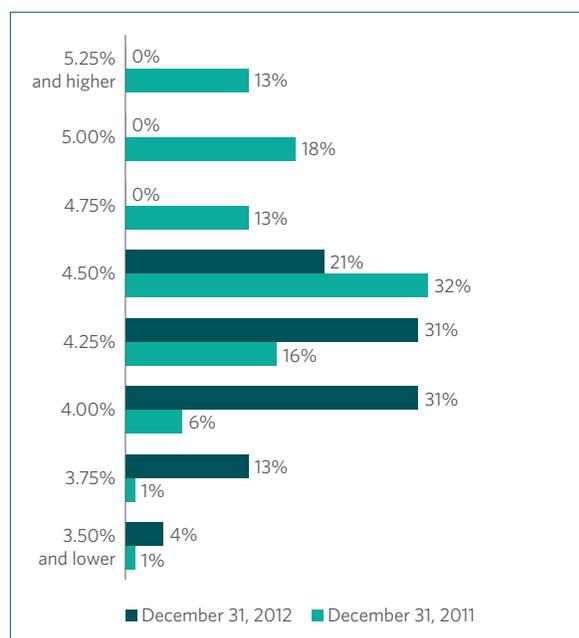
Accounting for publicly accountable enterprises has moved to International Financial Reporting Standards (IFRS) for fiscal years beginning on or after January 1, 2011. As such, this survey reflects assumptions and figures in line with IFRS. Note that international accounting for pension and benefits is also undergoing significant changes that will apply starting in 2013. A special section has been included to highlight the key items.

DISCOUNT RATE FOR PENSION PLANS

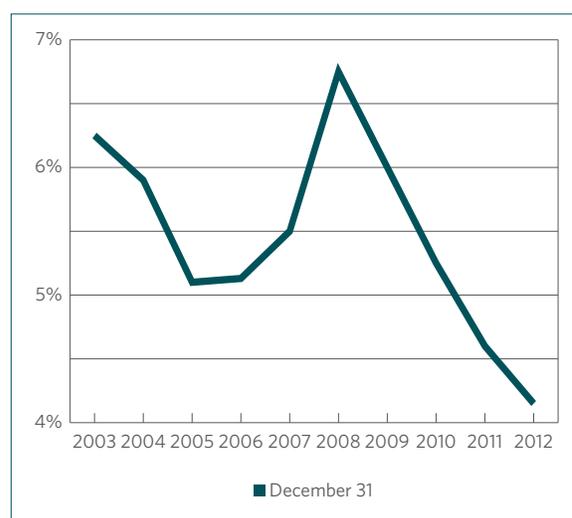
For a fourth straight year, the discount rate has declined by a significant amount (see the Appendix for a description of “discount rate”). Over the four-year period from 2009 to 2012, the median discount rate decreased by a total of 2.60% (0.75%, 0.75%, 0.65% and 0.45% respectively). The median discount rate was 4.15% as at December 31, 2012 compared to 4.60% a year earlier. Roughly 95% of companies surveyed reduced their discount rate in 2012, the median decrease being 50 basis points (“bps”).

The following charts summarize the discount rates (rounded to the nearest 0.25%) used in the valuation of defined benefit pension plans as at December 31, 2012, as well as the historical evolution of the median discount rate over the last 10 years, based on our past surveys.

DISCOUNT RATE/PENSION PLANS



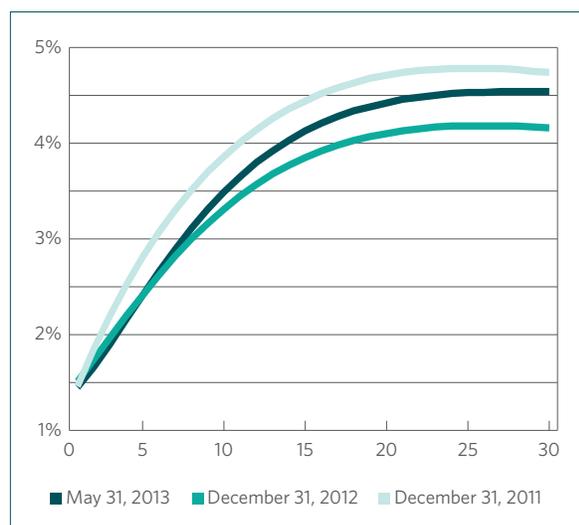
HISTORICAL EVOLUTION OF THE MEDIAN DISCOUNT RATE



The range in discount rates used has narrowed, compared to last year. About 83% of companies used a discount rate between 4.00% and 4.50% (a range of one half percent), while 84% of companies used a discount rate between 4.00% and 5.00% (a range of one full percent) at the end of the preceding year.

Over time, the yields on high quality long term corporate bonds may vary considerably. The discount rate should be expected to vary in a similar fashion. The graph below compares the spot rate curves as at December 31 for the years 2011, 2012, and more recently for May 2013. Spot rate curves, provided by Fiera Capital, are based on the methodology suggested by the CIA Educational Note, published in September 2011.

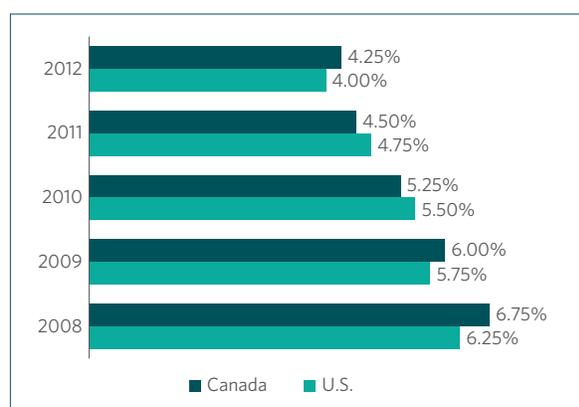
HIGH-QUALITY CORPORATE BONDS



If the spot rate curve were to remain at May 2013 levels until the end of the year, the expected discount rates at December 31, 2013 would be about 20 to 30 bps higher than those used at December 31, 2012.

The following chart compares the median discount rates (rounded to the nearest 0.25%) in our survey to the average discount rates from a U.S. study¹ (rounded to the nearest 0.25%).

MEDIAN DISCOUNT RATE BY COUNTRY



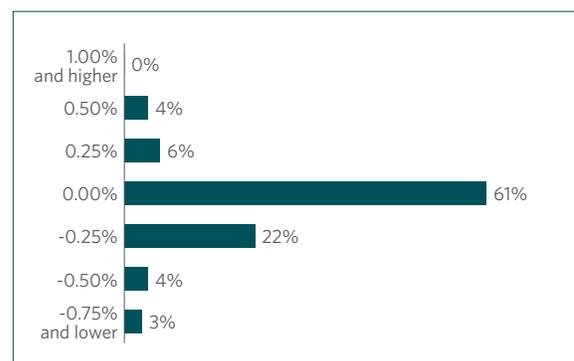
DISCOUNT RATE FOR NON-PENSION BENEFITS

The duration of non-pension post-employment benefits is often significantly different from that for pensions. For example, the duration of the defined benefit obligation (“DBO”) for a retiree medical plan is often longer than that for pension plans. As a result, the choice of discount rate for the valuation of post-employment benefits can be different than it is for pensions, in theory. (See the Appendix on selecting the discount rate for more on this.) While some companies use rates that differ by type of plan, many elect to use a single blended rate, or they simply use the rate for the most material plan.

The median rate used as at December 31, 2012, for non-pension benefits is 4.10%, which is only 5 bps lower than the median rate used for pensions.

The following chart shows the difference between the discount rate used in the valuation of non-pension benefits and that used for pension plans, rounded to the nearest 0.25%. (A positive value indicates a higher rate for non-pension benefits than for pensions and vice versa.)

DIFFERENCE IN DISCOUNT RATES (NON-PENSION BENEFITS VS. PENSIONS)



In 2012, most companies surveyed used similar discount rates for pensions and non-pension benefits. Only 10% of companies used a significantly higher discount rate for non-pension benefits (compared to 8% in our previous survey).

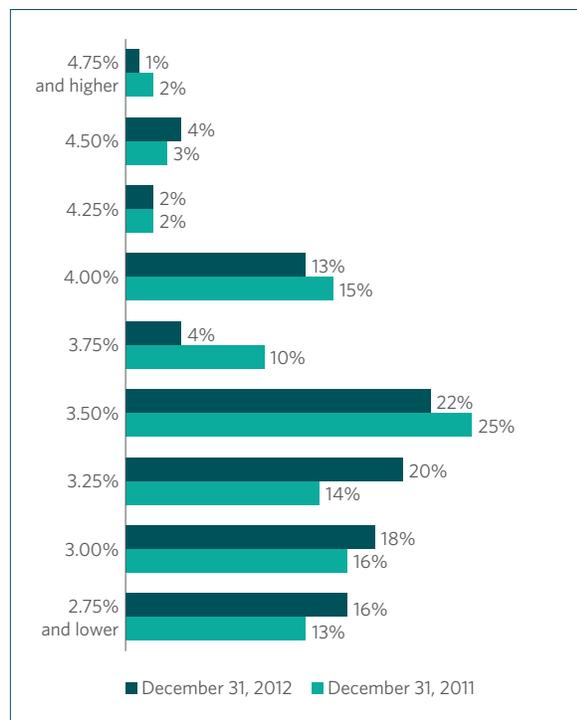
¹ Source: 2013 Study of Economic Assumptions, prepared by Deloitte & Touche Human Capital Advisory Services (U.S.).

RATE OF COMPENSATION INCREASE

Plans that provide pay-related benefits are required to make an assumption about the rate of compensation increases. International accounting standard 19 (“IAS 19”) indicates that it should reflect “inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market”.

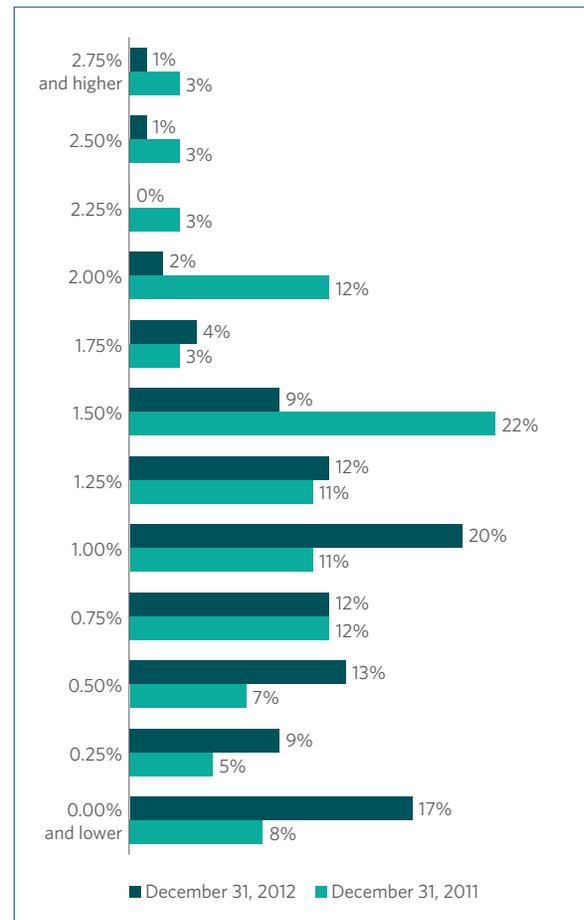
The median compensation increase assumption as at December 31, 2012, was 3.25%, which is 25 bps lower than last year’s median. We found 77% of companies using rates between 3.0% and 4.0%. In some cases, however, this assumption is much lower than the median, leading one to question whether some companies are properly reflecting the impact of individual job progression in their disclosed assumption.

RATE OF COMPENSATION INCREASE



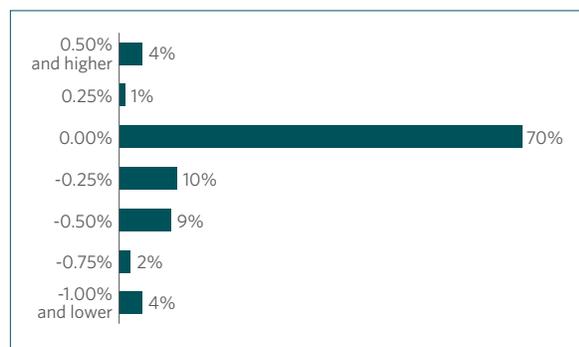
The following graph shows the spread between the discount rate and the rate of compensation increase. The spread can have a significant impact on the DBO for defined benefit pension plans. The median spread is 0.85% as at December 31, 2012, which is 45 bps lower than last year. The decrease in the spread has resulted in a higher DBO.

SPREAD: DISCOUNT RATE/COMPENSATION



Our survey shows that only 30% of companies changed the rate of compensation increase assumption by approximately 25 bps or more (up or down) at December 31, 2012. There is some debate over how frequently this assumption should be changed. IAS 19 states that financial assumptions shall be based on market expectations at the end of the reporting period.

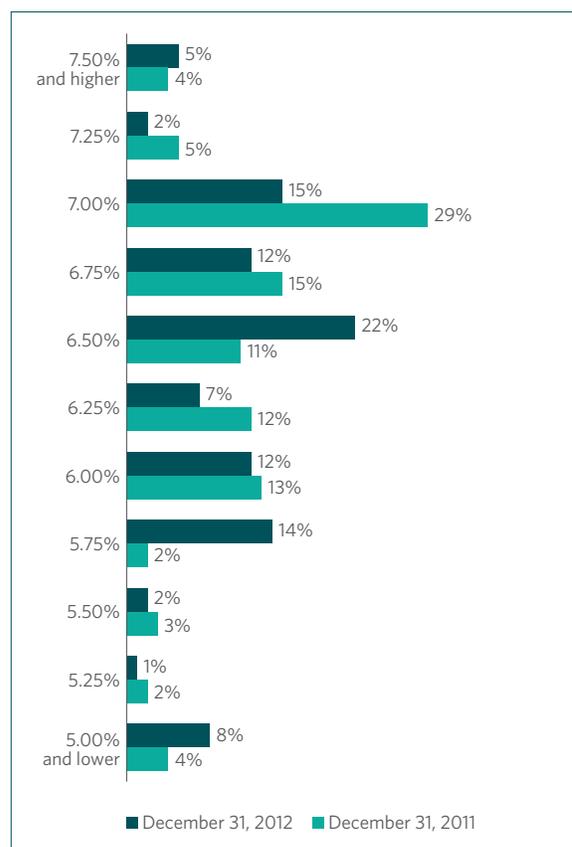
CHANGE IN COMPENSATION INCREASE ASSUMPTION (2012 VS. 2011)



EXPECTED LONG-TERM RETURN ON PLAN ASSETS

IAS 19 specifies that the expected rate of return on plan assets should reflect a long-term view since it is based on the entire life of the related obligation. The following chart shows the return assumption disclosed at the end of 2012 versus 2011.

EXPECTED RETURN ON PLAN ASSETS

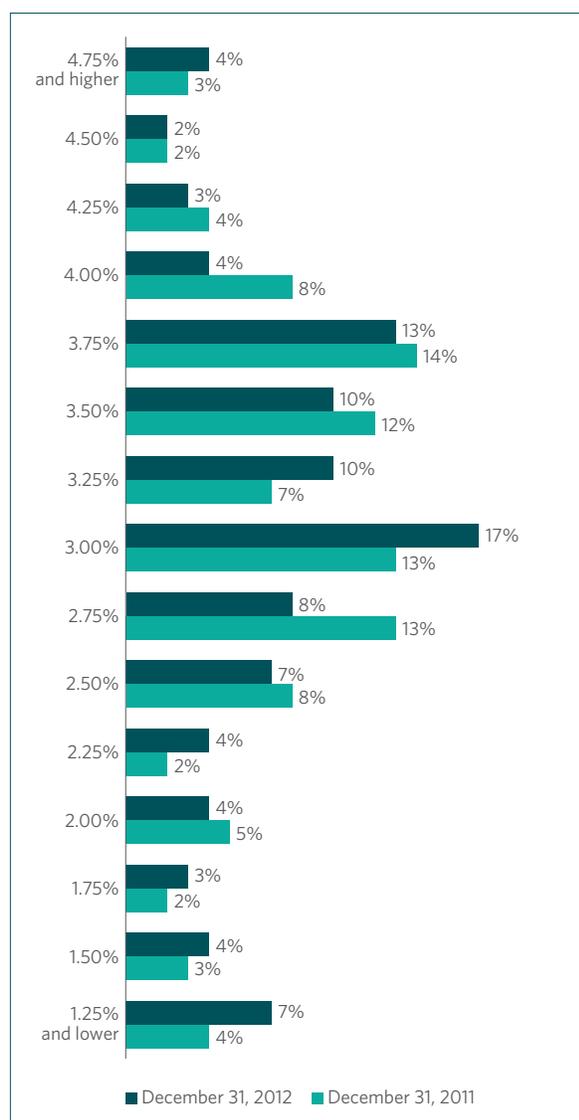


The median expected long-term rate of return on plan assets is 6.50%, a 25 bp decrease from the median rate in the December 31, 2011 survey. In recent years, there has been a very slow but steady decline in this assumption. The range in this assumption used is similar to last year's. Approximately 68% of the companies used a long-term rate of return between 6.00% and 7.00% as at December 31, 2012, whereas 72% of the companies used an assumption between 6.25% and 7.25% at the end of last year.

For most pension plans, the actual return earned in 2012 was higher than the assumed long-term rate of return on assets. The actual median return for diversified pension funds was 9.15% in 2012 according to the *Performance Universe of Pension Managers' Pooled Funds* produced by Morneau Shepell.

The following graph shows the spread between the expected return on plan assets and the rate of compensation increase. The median spread was 3.00% as at December 31, 2012, a slight decrease from last year's median of 3.10%. It is expected that this spread would be fairly stable from one year to the next.

SPREAD: EXPECTED RETURN ON PLAN ASSETS/COMPENSATION

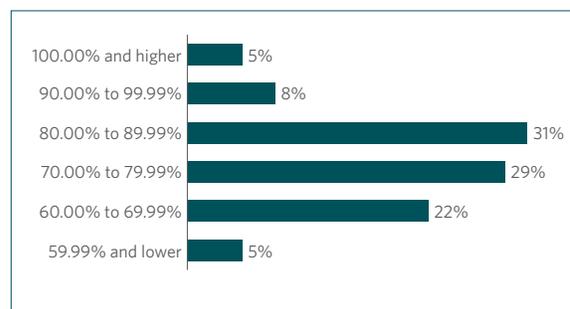


Our survey results show that about 45% of companies reduced the spread by approximately 0.25% or more as at December 31, 2012.

PENSION PLAN FINANCIAL SITUATION AND FINANCIAL ASSUMPTIONS

The companies in our survey show an 83% overall ratio of pension assets to DBO for accounting purposes. This result may be slightly understated since it includes some non-registered plans for which no funding is legally enforced under the Canadian regulatory environment. The ratio is highly influenced by the actual return on plan assets, the discount rate assumption and special contributions made to cover pension plan deficits. The distribution of companies based on their overall ratio at December 31, 2012 is shown in the following chart.

PENSION PLANS RATIO OF ASSET VALUE TO ACCOUNTING DBO (DISTRIBUTION OF COMPANIES)



As mentioned, the ratio is highly influenced by return on assets and discount rate, for which we have summarized historical data in the next chart.

KEY FINANCIAL ASSUMPTIONS AND ACTUAL RETURN ON ASSETS



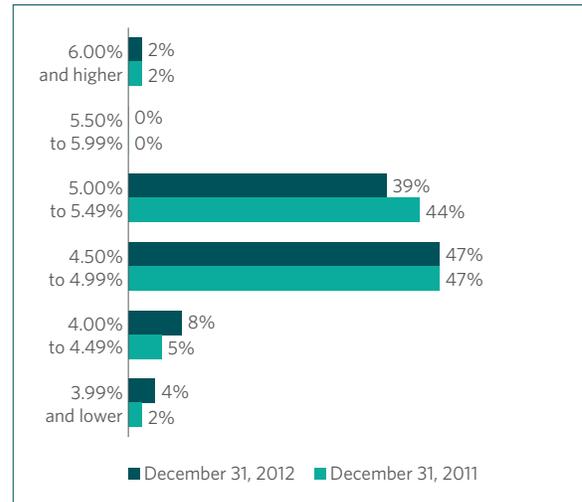
MEDICAL COST TREND

When retiree medical coverage is offered, a key assumption in the valuation of the DBO is the rate of future medical cost increases. IAS 19 provides guidance on factors that companies should consider in selecting this assumption.

Often, medical costs are assumed to increase at a higher rate in the short term, declining in steps to an ultimate rate over a period of several years.

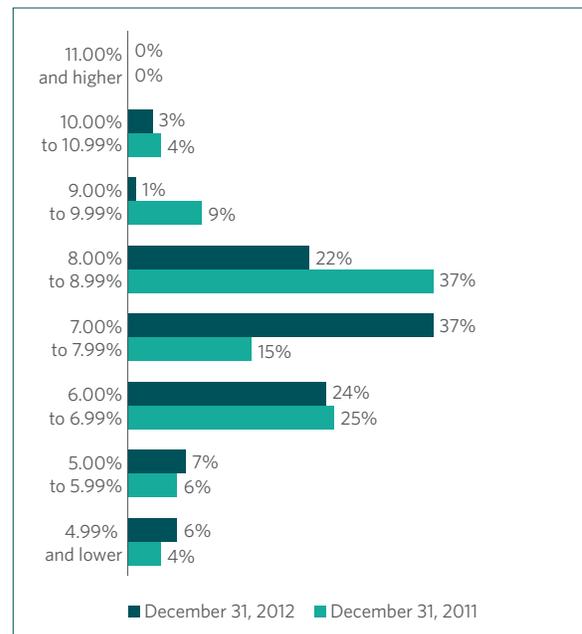
The following charts show the December 31, 2012 medical cost trend assumption compared to December 31, 2011. About 86% of companies used an ultimate trend rate between 4.5% and 5.5%. The median rate as at December 31, 2012 is 4.6%, a 20 bp decrease compared to last year.

ULTIMATE MEDICAL COST TREND



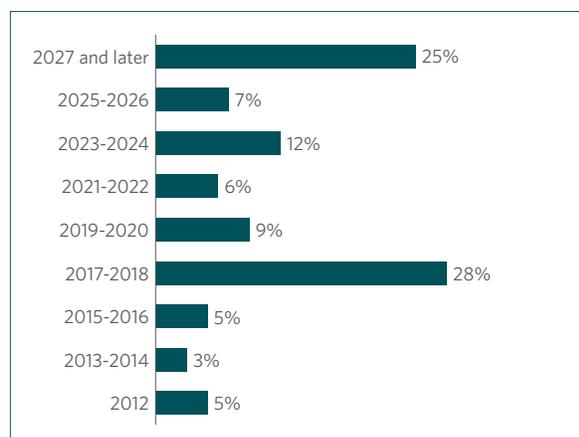
The median assumption for the short-term medical cost trend rate was 7.0%, a 100 bp decrease compared to last year. There has been a continuing decrease in the number of companies using an assumption of 10% or higher, with just 3% of companies now in this category compared with 4%, 6%, 9%, 19% and 28% respectively in the 5 preceding years. A total of 74% of companies used an assumption of less than 8% (compared to 50% in 2011), confirming the reduction of medical cost growth across the market.

SHORT-TERM MEDICAL COST TREND



The median year in which the medical cost increase rate reaches the ultimate rate is 2021, which is 2 years later than last year's median year, and 3 years later than the median observed in 2009. This confirms the common practice of adjusting the calendar year in which the medical cost trend assumption reaches its ultimate trend rate, for the sole purpose of keeping the same projection period from year to year. The median projection period has been reasonably stable since 2009 (9 years). We will continue to pay close attention to this assumption in future surveys.

ULTIMATE MEDICAL COST TREND (YEAR IN WHICH ULTIMATE RATE IS ATTAINED)

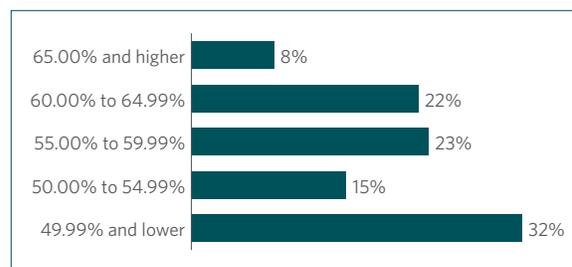


PENSION PLAN ASSET ALLOCATION

Under IAS 19, the allocation of pension fund assets between equities, fixed income and other assets must be disclosed. Additional categories may be added to facilitate the readers' understanding of the investment risks faced by the fund.

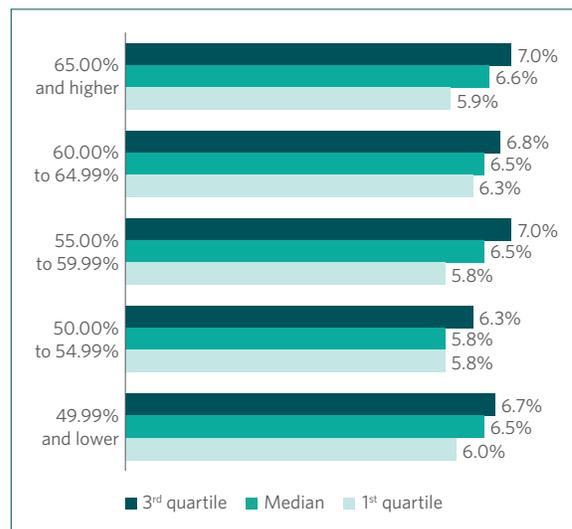
The average asset allocation as at December 31, 2012, was 53% in equities, 42% in fixed income and 5% in other assets, which is identical to last year's survey. The distribution of the proportion of funds invested in equities is shown below:

COMPANY DISTRIBUTION BY PENSION PLAN EQUITY WEIGHTING



Since the expected long-term return on assets assumption is based in part on asset allocation, we have compared the assumption used to the equity weighting. Theoretically, a pension plan holding a higher proportion of its assets in equities should have a higher expected rate of return on assets than a pension plan with a lower equity allocation. However, based on recent surveys, our findings make it difficult to support that theory.

LONG-TERM RATE OF RETURN ASSUMPTION FOR VARYING LEVELS OF EQUITY

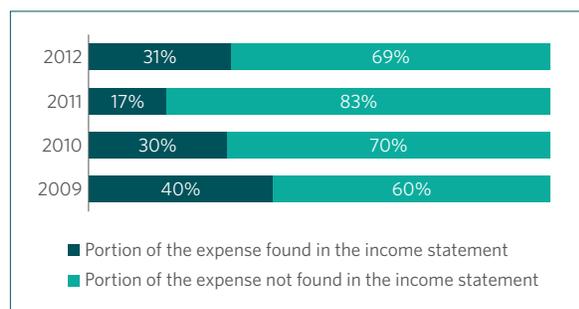


PENSION EXPENSE BEFORE AND AFTER ADJUSTMENT

This 2013 survey presents results for companies with a total of \$151 billion in pension assets. The following graph shows the ratio of the pension expense after adjustment to the pension expense before adjustment in aggregate for all companies in our survey. The expense after adjustment is the actual expense recognized in the income statement. The expense before adjustment is the notional expense one would experience in a full mark-to-market accounting environment (i.e. one in which there is immediate recognition of all changes in assets and DBO in the expense). In 2012, the total recognized expense amounted to \$3.3 billion (after adjustment). In the absence of any deferral mechanism in the income statement or recognition in other comprehensive income, the expense before adjustment would have been \$10.5 billion.

Most pension plans experienced losses in 2012 (mainly due to decreasing discount rates). Therefore, the adjustments made in 2012 generally recognized less actuarial losses in the income statement, resulting in a reduced pension expense.

RATIO OF PENSION EXPENSE AFTER ADJUSTMENT TO THE PENSION EXPENSE BEFORE ADJUSTMENT



With IAS 19 in force since 2011, companies must apply one consistent method of recognition of gains and losses. It is possible to recognize gains and losses immediately or gradually in the pension expense (immediate recognition or “corridor” approach), or recognize them in other comprehensive income. According to our survey, 72% of companies recognize gains and losses in other comprehensive income.

UPCOMING CHANGES TO INTERNATIONAL ACCOUNTING STANDARDS

As mentioned earlier, accounting for Canadian publicly accountable enterprises is now subject to International Accounting Standards, which lead to a transition process in 2011.

Another transition is expected in 2013 as changes to pension and benefits accounting will apply.

The key modifications are:

- No deferral of gains and losses and past service costs;
- Increased volatility in the statement of financial position through other comprehensive income;
- Different presentation of pension and benefit plans expense components (operating, financing and re-measurements);
- Expected return on assets assumption not used (replaced by use of the discount rate);
- More comprehensive disclosure requirements (mostly related to risks).

Please consult our [July 2011 News & Views](#) publication (available on our website) for details on the changes.

FOR MORE INFORMATION

This survey is intended to provide information regarding the assumptions disclosed by a wide range of companies and, as such, can provide an indication of trends. The assumptions used for your own employee benefit plans will depend on a number of factors.

For more information, please speak to your Morneau Shepell consultant.

APPENDIX

SELECTING THE DISCOUNT RATE

In general, the DBO is highly sensitive to the discount rate assumption. For example, a 25 bp decrease in the discount rate can increase the DBO by as much as 5%, which would in turn increase the annual expense for future years.

IAS 19 standard provides general guidance for the selection of the discount rate assumption. The discount rate should be determined by reference to market yield on high-quality corporate bonds. In countries where there is no deep market in such bonds, the market yield on government bonds shall be used. The discount rate shall reflect the estimated timing of benefit payment, but it is common practice to apply a single weighted average rate. However, the precise methodology for computing this rate is not prescribed.

The Canadian Institute of Actuaries (CIA) published an *Educational Note* in September 2011, which offers advice to pension actuaries who are engaged to provide guidance to pension plan sponsors, specifically on the discount rate to use for accounting purposes.

The *Educational Note* describes a methodology to extrapolate the long end of the high-quality corporate yield curve that the Task Force believes would be appropriate in the current economic environment. This new methodology uses high-quality corporate and provincial (adjusted) bonds and could result in many cases in a discount rate lower than that obtained under the previous methodology given current conditions in financial markets. However, it is our understanding that some entities may not have applied the proposed methodology set forth by the CIA in establishing the discount rate as at December 31, 2011 and 2012, using an alternative model or even continuing with the previous method.

Information on high quality Canadian corporate and provincial bonds (rated AA or higher) is generally available from independent sources, and can serve as a starting point in the determination of the discount rate.



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