Office of the Auditor General of Ontario
Bureau du verificateur general de !'Ontario

September 26, 2016

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Deputy Minister, Treasury Board
Secretary of Treasury Board and
Management Board of Cabinet
Deputy Minister's Office
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Mr. Scott Thompson
Deputy Minister
Ministry of Finance
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Dear Mr. Orencsak and Mr. Thompson:

Re: Finalizing 2015-2016 Public Accounts and the Pension Asset Issue

Thank you for your letter received yesterday afternoon. I too am glad that the other issues raised during this year's audit have been addressed and I value the effective working relationship my staff and yours have had in past years. It is unfortunate that the subject issue is outstanding so near to the statutory deadline for the tabling of the Public Accounts. Our concern regarding the pension asset was raised in June of this year after I requested my audit team to perform further work on pensions as part of the Public Accounts audit and in relation to a special section we were planning to dedicate to pensions in Chapter 2 of this year's Annual Report.

I was informed a few weeks ago that Deloitte LLP ("Deloitte"), the firm at which the new Provincial Controller was formerly a partner, was providing advice to the Ontario Provincial Controller's Division (OPCD). Reference to their opinion was made in the province's legal letter dated September 11, 2016 that we received earlier this month. It states: *"The Deloitte Report sets out an accounting analysis supporting the recognition of the surplus as an asset for the purposes of reporting the Province 's financial position, as assessed in accordance with Public Sector Accounting Standards ..... While the Deloitte analysis speaks to Ontario benefitting from surplus withdrawal, the Office of the Provincial Controller Division (OPCD) in Treasury Board Secretariat has advised that the analysis under Public Sector Accounting Standards completed by Deloitte demonstrates that no surplus withdrawal is necessary to support the asset recorded in Ontario's Public Accounts".* Given that OPCD was representing that they had a strong accounting position supported by Deloitte at that point in time, we were definitely interested in obtaining a copy to understand the basis ofOPCD's position on the Pension Asset. At your request, we met with five representatives from Deloitte at your Office in the Whitney Block on September 14, 2016. I was under the impression at that time that Deloitte was already under contract to provide an accounting opinion to OPCD and requested to obtain a copy.

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Our expectation was, because you believed that Deloitte's opinion was strong, that Deloitte would confirm that as at March 31, 2016, the province's recorded pension asset of $10.6 billion is an asset and one that is properly valued and therefore recognized in accordance with all sections ofPS3250 -Retirement Benefits, PS3210- Assets and PS3320- Contingent Assets.

This is the same level of assurance that I must provide to the readers of the Province's consolidated financial statements when I sign an unqualified audit opinion of the Province's Consolidated Financial Statements. To date no such opinion has been received by my Office to review and assess. Anything less from Deloitte LLP would be a clear indication that they are not fully convinced that the Province's accounting position for the Pension Asset is defendable in accordance with all sections of PS3250, PS3210 and PS3320.

I was definitely surprised when on September 19, 2016 I received an email of a "Statement of Facts" from a Senior Manager of Deloitte requesting that we confirm whether the facts provided to them by the OPCD were accurate. Given that they were hired by OPCD, it seemed unusual, but we provided feedback on September 20, 2016. It was not until a meeting on September 21, 2016 with the Controller and a Partner and Senior Manager from Deloitte that I learned that Deloitte had been engaged on September 19,2016 to conduct a Section 7600 review. At that point, I requested copies of their engagement letters to understand what they would be doing so that we would know how to respond to their more formal request for confirmation on facts in an amended document. On Friday, September 23, 2016 we received the last of copies of their engagement agreements. On Sunday morning, September 25, 2016, I provided additional email feedback to the Partner at Deloitte on an email received around 11:00 pm on September 21, 2016 and an updated Statement of Facts received on September 23, 2016. Our feedback indicated that their facts were not complete and I suggested they consider a few additional points. The documents we obtained also confirmed that the OPCD has also retained PricewaterhouseCoopers LLP ("PwC") to potentially provide an opinion. I have not yet been contacted by PwC.

As you've indicated, both my team and I have had several discussions with you and the OPCD, particularly the Controller and her Director on this matter. For further clarity, I will outline several other items (previously verbally communicated) that must be taken into account when reaching a conclusion on the accounting issue at hand. Our position is not based solely on the points you note in your letter.

We note that the OPCD position outlined in your letter of September 25th is based on the following assumptions:

OPCD Position	OAG Res_I!_onse	OAGReason
The decrease in the amount of future contributions, pertaining to "share the pain" payments, in the amount of$7.8 billion ($4.3B in 2016, $1.9B in 2016, and $1.6B in 2014) supports the currently recorded value of the pension asset.	Disagree	Although the elimination of the "share the pain" payments are reductions from a funding perspective, their discontinuance does not have a material impact on the discussion of the value of the pension asset on an accounting basis.
That PS3250.052 does not require that there be no uncertainty in order to recognize an asset.	Disagree	PS3320.03 notes that contingent assets arise from conditions or situations involving uncertainty. Even where a future event is likely, a contingent asset would not be recorded in the financial statements, but rather only disclosed in the notes.
That PS3250.59 does not apply because it only applies to a discussion of withdrawals.	Disagree	PS3250.59 does apply. Once the adjusted benefit asset is calculated as per PS3250, PS3250.59 must be considered in assessing the government's control of a joint pension plan's assets and the ability the government would have to withdraw assets from the joint pension plan tests whether it has that control. Control is necessary to meet the definition of an asset. Further, PS3250.059 informs PS3250.052 as the latter triggers the need to consider an impairment when uncertainties exist surrounding the Province's legal right to use a plan's accounting surplus.
…so to apply a test requiring no uncertainty to the recognition of an asset is inconsistent with the accounting for pension plans as a whole.	Disagree	The certainty issue in PS3250 relates to recognition of an asset, not pension accounting as a whole.
That the word "expected" in expected future benefit does not equate to certainty.	Disagree	The word expected equates to the absence of uncertainty in re cognizing a pension asset under PS3250.

Unfortunately we continue to disagree that these points support maintaining the Pension Asset on the province's consolidated financial statements. Note disclosure of the Pension Asset would be appropriate. It is important to note that in accounting, "expectations" do not lead to the booking of assets in financial statements. If this were the case, we would record revenue receivable this year from cap and trade because the government expects to raise revenue from this in the future.

The following provides additional commentary on why we believe that the Pension Asset should be removed from the balance sheet.

A. Conceptual Framework- Clear Presentation of Annual Pension Expense – Reflect an Asset on the Balance Sheet Only When There is Actual Control Over That Asset

1. As per PS3250.005 "The standards in this Section are based on the accounting framework recommended in PS1100 and PS1201. That framework emphasizes the need to account for all liabilities incurred by a government to help legislators, taxpayers, investors and other users of financial statements assess: a government's future cash requirements from taxes and other revenues..." It is important to consider that Section PS3250 Retirement Benefits simply applies the definition of an asset, liability, revenue and expense to retirement benefits. A key consideration is that the public sector entity controls the economic resource and access to the future economic benefits and that the transaction or event giving rise to the public sector entity's control has already occurred. An entity that controls an economic resource has the ability to deny or regulate access to the future economic benefits by others. In the case of Ontario Teachers' Pension Plan ("OTPP" or the "PLAN"), the economic resources are jointly controlled by the Government and the OTF. The economic benefits are to flow to the beneficiaries. This reality can only change if specific agreements (in addition to the Partners' Agreement and the Funding Management Policy) enable government to access those economic resources. As well, a further requirement is that approval from the Financial Services Commission of Ontario is needed for any PLAN impact/changes that could, if approved, lead to the government obtaining an asset. Applying this understanding leads to a clear presentation ofthe government's annual pension expense.

B. Annual Evaluation of a Pension Asset (If there is unilateral legal control, there is an Asset; if not there is an Annual Pension Expense impact from minimum and other contributions)

2. It is important to consider all ofPS3250 -Retirement Benefits, PSlOOO- Financial Statement Concepts, and PS321O– Assets when evaluating whether the Province has a pension asset on its financial statements that is correctly valued. An opinion on whether there is a supportable Pension Asset should not be based only on actuarial calculations for the purpose of Section PS3250.056(a). All sections should be considered. The need for a valuation allowance must be considered.

a. PS3250.055 states the objective ofPS3250.050 (An accrued benefit asset should be presented on a government's statement of financial position net of any valuation allowance) is to limit a government's accrued benefit asset to the amount it <u>can</u> realize in the future (versus "may" access or "expects" to access in the future).

b. The actuarial calculations performed by Deloitte contain assumptions that are subject to judgment with respect to the years of future contributions payable. The assumptions used under three views were that contributions would cease immediately, in two years and in eleven years. Given that government pension plans have and will continue to exist for many years, this short-term view is likely not appropriate. When contributions extend to 50 years, the calculation of expected future benefit under PS3250.056(a) is reduced significantly. Having said this, a valuation allowance is still required to be considered separate from the calculation performed under PS3250.056(a) to support an opinion that the Province's Pension Asset is properly recorded (recognized) in accordance with Public Sector Accounting Standards (i.e. meets PS3250 as a whole, meets the definition of an asset under PS1000 – Financial Statement Concepts, and also meets the test ofPS3210- Assets).

c. Under PS3250.54 when the adjusted benefit asset is larger than the expected future benefit, the pension asset is considered impaired and a valuation allowance is required. An actuarial calculation is the first step in this process to ensure the Pension Asset is below a ceiling. However once this figure is calculated, Section PS3250.059 must be considered in assessing the government's control and access over the PLAN asset and the ability the government would have to withdraw assets from the PLAN tests whether it has that control. The expected future benefit would include amounts to which a government has a legally enforceable right of withdrawal. A government may not anticipate obtaining a legally enforceable right to withdraw a portion of a plan surplus to which it is not currently entitled, whether on the basis of precedent or otherwise. Accordingly, when withdrawal of plan surplus requires the approval of employees or an appropriate regulatory authority or a court of law, a government excludes any amount subject to this restriction from its expected future benefit until such approval has been obtained. As such, because there are no agreements in place supporting any form of surplus reduction, the accrued benefit asset has uncertainty that it can be realized and its value at this point in time is zero. However, when the Province obtains the proper approval, the valuation allowance would be adjusted and a pension asset would result from the respective value associated with withdrawal, contribution holidays or the receipt of a refund of contributions.

d. A change in the allocation of surplus between a government and its employees is incorporated into the calculation of the expected future benefit only when it has been agreed to and when required, approved by the appropriate regulatory authorities.

e. The view being suggested by OPCD would avoid transparent reflection of the impact of annual cash contributions on pension expense in the government's annual financial statements, which is not the intent of PS3250.

C. Additional Support for Why a Valuation Allowance is Applicable

3. The definition of a plan asset is set out in the Glossary to PS3250. A plan asset is an asset segregated and restricted in a trust or other legal entity separate from the government to provide for retirement benefits under the following conditions:
   a. The assets in the separate entity are to be used only to settle the related accrued benefit obligation, are not available to the government's own creditors, and either cannot be returned to the government or can be returned to the government if the remaining assets of the trust are sufficient to meet the plan's obligations; and
   b. To the extent that sufficient assets are in the entity, the government will have no obligation to pay the related retirement benefits directly.

4. A plan asset, for the purposes ofthe plan itself and for accounting purposes must meet the definition of an asset. As well, a plan asset must also be set aside in a separate entity (i.e. a trust), at which point the government loses control over those assets.

5. It is useful to note that (a) above is in place to prevent a government from simply allocating assets within its own entity to its pension liability that are not segregated or restricted. Thus the need for having a trust or separate entity to meet the requirement that the assets are not available to the government's general creditors. In other words, the government must have given control over the economic benefits inherent in the assets to another entity. An entity could include the pension plan, trust or other entity appointed to administer the asset. This is important because this definition causes the government to give up control of an asset. If the government still maintains control over the asset, it would be available to the government's own creditors.

D. Important to Distinguish between Funding Surplus/Deficit and Accounting Surplus/Deficit and Control over PLAN assets

6. It is important to distinguish between a funding surplus/deficit and an accounting surplus/deficit when assessing this issue. The subject we are dealing with is "an accounting surplus". The funding objective is to determine an acceptable policy for financing the estimated ultimate cost of a benefit plan. The accounting objective is

to measure and report the obligation for the benefit plan and to attribute the costs of those benefits to the periods in which related services are rendered.

7. It is equally important to recognize that the Teachers' Pension PLAN reflects a pension liability on its financial statements in contrast to a pension asset (a.k.a. accounting surplus) on the Government's financial statements both for accounting purposes.

8. The Board of the Ontario Teachers' Pension Plan acts as trustee when it administers the trust on behalf of the beneficiaries specified in the agreement or statute. As trustee, it administers the assets of the PLAN, following the terms and conditions set out in the relevant agreements. The Board does not control the assets of the PLAN because it does not have access to the future economic benefits. As well, neither of the joint sponsors (OTF and the government) unilaterally control the assets or have legal access to the future economic benefits. Those benefits of those PLAN assets flow to the beneficiaries. It isn't until there is a clear negotiated agreement between the joint sponsors, and the approval of the Superintendent of the Financial Services Commission of Ontario that legal access and control of assets can be provided to the government.

9. The Ontario Teachers' Pension Plan is responsible for reflecting the financial results and assets of the Pension Plan. The Government is a sponsor to the plan and therefore would pay its required contributions, record its annual pension expense and recognize its pension liability.

E. Impact of Restoration Related to "Share the Pain" on the Accounting Surplus

10. The suggestion that the $4.3 billion, $1.85 billion and the $1.95 billion are relevant, in a material way, to support a Pension Asset on the government's consolidated financial statemeJ;J.tS is not the case. These are funding impacts and not accounting determined figures. The Government has only contributed approximately $3.2 million as part of the "Share the Pain" issue. The values noted above, totaling $8.1 billion assume a funding benefit resulting from the Government discontinuing these additional payments in the future. As well, the payments were to be a short te1m measure. Because the liability for pension accounting is only affected by obligations to pensioners versus a change in additional short-term payments, the $8.1 billion is not relevant as a means of justifying the $10.1 billion Pension Asset related to the Teachers' Pension Plan on the province's financial statements. The impact of discontinuing the payment of the "Share the Pain" amounts does not provide a significant material benefit to the province from an accounting perspective. The "Share the Pain" is a start and stop payment that does not affect minimum contributions. This is immaterial to the discussion of the value of the Pension Asset on an accounting basis. This could potentially support the booking of a Pension Asset for at most $10,000,000 based on information known to date.

The Government is ending a short-term additional payment commitment. There is no significant recovery to be recognized in accounting from ending this commitment.

11. Government payments to OTPP currently include a 1.1% special contribution, in addition to the minimum contribution, until 2026. Any changes, including the reduction or elimination of these special contributions, are subject to negotiation and agreement between the joint sponsors. If agreement were reached to cease this special payment, it would end a temporary additional payment commitment.

F. Public Expectation of the Province Unilaterally Controlling/Accessing PLAN Assets

12. As at March 31, 2016, there was, and there continues to be no formal determination of what amount of the asset the Province can remove from the PLAN (i.e. 20%, 50%, 70%). In fact, there is no public expectation that the government can access existing assets of the Plan because all access has to be jointly negotiated with the OTF and approved by the Financial Services Commission of Ontario, which is publicly communicated to be an independent regulator. A belief of a government that there may be, someday an action enabling it to access assets of a pension surplus, does not address the reality of the situation. As at March 31, 2016, there was no strong beliefwith the Financial Services Commission of Ontario, the members ofthe Legislative Assembly, the taxpayers of Ontario, the Ontario Teachers' Federation or the teachers themselves that the Government was able to use the assets of the PLAN for reducing contributions, taking contribution holidays or withdrawing surpluses.

13. A government can only report an asset when the PLAN (Teachers) has a surplus based on the accounting requirements and not the funding requirements and there are existing authorities in place at the time of reporting that give the government a legally enforceable right to access those assets. PS3250.052 is very important "A government may benefit from an accrued asset either by withdrawing surplus assets or by taking a contribution holiday or receiving a refund of contributions. The accrued benefit asset may become impaired when there is a PLAN surplus for accounting purposes that the government is not entitled to benefit from fully. For example, there may be ...uncertainties as to a government's legal right to use a plan's accounting surplus." It is the occurrence of a past transaction or event on or before the financial statement date that distinguishes a present economic resource controlled by a public sector entity from an economic resource that may be controlled by a public sector entity in the future.

14. In the case at hand, there is no existing law, by-law or policy in relation to OTPP that gives rise to control of an economic resource. Control does not exist until an underlying event occurs (e.g. the government and the OTF reach a specific agreement and it is agreed to by the Superintendent of the Financial Services

Commission of Ontario if PLAN assets are impacted, or if new legislation is passed). Uncertainties exist regarding access and the extent of access to PLAN assets until proper process is followed.

15. Unless there is a specific agreement indicating a distribution of any surplus, in any form, a valuation allowance should be reported by the Province, bringing any reported asset value to zero or other appropriate value (e.g., if the Plan had net unamortized losses, which is not the case).

16. The government's expectation that it may reduce its future contributions (special or minimum) through future negotiations can be examined against the concepts in PS3320-Contingent Assets. PS3320.03 notes that contingent assets arise from conditions or situations involving uncertainty. Even where a future event is likely, a contingent asset would not be recorded in the financial statements, but rather only disclosed in the notes.

G. Results of Jurisdictional Review

17. Based on our review, few senior governments sponsor joint defined benefit pension plans that are in an accounting surplus position. We noted British Columbia's 2015 Summary Financial statements discussed their pension asset accounting treatment by disclosing: "The province has no claim on accrued asset amounts. If the individual pension boards decide to reduce or suspend employer contributions for a period of time, the province may record an asset. Therefore, the recorded value of the net assets is nil until such time such a decision is made." Similar accounting was used in British Columbia's March 31, 2016 Summary Financial Statements.

Our opinion on this issue was informed through research and external consultations. I am confident that a correction of an error is the appropriate accounting treatment required and that a Pension Asset should not be reflected in the province's consolidated financial statements for the year ended March 31, 2016. The suggestion that this is solely a measurement issue is incorrect. It is primarily an asset recognition issue where the asset would be adjusted to an amount that would meet the definition of an asset. In the case of the $10.6 billion recorded pension asset at March 31, 2016, this would be an adjustment to nil.

I look forward to our further discussion on this issue later today.

Sincerely,

Bonnie Lysyk
Auditor General

c. Ms. Cindy Veinot, Assistant Deputy Minister & Provincial Controller