Briefing Note

Office of the Provincial Controller Division
Accounting Policy and Financial Reporting

PSAB's Invitation to Comment "Employment Benefits: Deferral Provisions in Sections PS 3250 and PS 3255"

Issue:

The Public Sector Accounting Board (PSAB) has requested comments on an Invitation to Comment (ITC) on Employment Benefits: Deferral Provisions due March 3, 2017.

Project Status:

- RETIREMENT BENEFITS, Section PS 3250 was revised and issued in September 2001 replacing the prior EMPLOYEE PENSION OBLIGATIONS, Section PS 3250 which was based on Accounting Statement No. 5. POST-EMPLOYMENT BENEFITS, COMPENSATED ABSENCES AND TERMINATION BENEFITS, Section PS 3255 was issued in May 2002. The requirements in Section PS 3255 were developed to be consistent with the recommendations in Section PS 3250. No changes have been made to either Section PS 3250 or Section PS 3255 since 2001 and 2002, respectively, other than those of an editorial nature.
- This project is directed at developing a new, comprehensive Handbook Section for the CPA Canada Public Sector Accounting (PSA) Handbook on employment benefits which will replace existing Sections PS 3250 and PS 3255. Due to the complexity of the issues involved, PSAB decided to undertake this project in two phases. Phase I will address specific issues related to the measurement of employment benefits, including the deferral provisions and the discount rate guidance in the standards. The scope of this ITC is the deferral provisions in Sections PS 3250 and PS 3255.
- An Invitation to Comment on the guidance in the standards on discount rates, the next stage of the project, is expected to be issued by PSAB later in 2017.

Background:

- The Province sponsors several pension plans. It is the sole sponsor of the Public Service Pension Plan (PSPP) and joint sponsor of the Ontario Public Service Employees Union (OPSEU) Pension Plan and the Ontario Teachers' Pension Plan (OTPP). In addition to the Provincial sponsored plans, pension benefits for employees in the hospital and colleges sectors are provided by the Healthcare of Ontario Pension Plan (HOOPP) and the Colleges of Applied Arts and Technology Pension Plan (CAATPP) respectively, and are included in the Province's financial statements.

- The Province of Ontario complies with the deferral provisions in Sections PS 3250 and PS 3255 as follows.

  1. For plan assets: The Province of Ontario values sponsored and joint sponsored pension plan assets by adjusting to market value over a period of five years in accordance with Section PS 3250, paragraph .035 (i.e. at market related value). Unexpected returns associated with a change in value of plan assets are included as a component of the actuarial gains and losses. Actuarial gains and losses are amortized to the statement of operations over the expected average remaining service life (EARSL) of the related employee group.

  2. For accrued benefit obligations: Changes in actuarial assumptions and experience adjustments are also included as a component of the actuarial gains and losses. The Province accounts for actuarial gains and losses on pension plans and for other employee future benefits by amortizing these amounts over the EARSL of plan members for each respective plan in accordance with Section PS 3250, paragraphs .061 and .062 and Section PS 3255, paragraph .24.

- The deferral provisions in Sections PS 3250 and PS 3255 which consider the long-term nature of pension plans reduce the year-to-year volatility on the statement of operations from changes in the market value of plan assets and changes in the accrued benefit obligations. An elimination of the deferral provisions would result in a more immediate impact on the statement of operations, net debt and accumulated surplus/deficit. The impact of eliminating the market related value option for plan assets in relation to the Ontario Teacher's Pension Plan is illustrated in Appendix 3.

- The objectives and users of government financial statements are different from those in the private sector. A primary objective of government financial statements is to demonstrate accountability by the government to the public and its legislature. Financial statements are a vehicle by which governments demonstrate whether they did or did not do what they intended and why or why not. Government financial statements should therefore be clear and understandable to the public. Pension plans are long-term in nature. Because of the long-term nature of pension plans, government's long-term accountability should be demonstrated to the public with respect to pension plans. Standards on retirement benefits in the PSA Handbook should consider the long-term accountability of government to the public.

- Since governments operate under balanced budget legislation, where such budgets are prepared on a consistent basis as financial reports, public sector accounting standards can also impact fiscal policy decisions. For example, an in year improvement in the market value of pension assets where market related values and amortization over EARSL is eliminated, may result in decisions which increase spending in order to achieve balanced budget. Such spending would be funded through increased borrowing and may not be in the public interest and the reported gain in one period may be followed by losses in the subsequent period.

- The legislature is a key user of government financial information in this regard, whereas credit rating agencies tend to focus more on cash flow related metrics. In the "Comments requested" section of the ITC reference is made to "external" users' needs with regards to decision making, without acknowledgement of the impact that public sector financial standards can have on internal decision makers. This wording deviates from PSAB's strategic plan which more appropriately includes internal users of government financial information as well.

Analysis:

Valuation of Plan Assets

- Section PS 3250, paragraph .035 allows plan assets to be recorded at market value or adjusted to market value over a period not to exceed five years. As previously mentioned, the Province of Ontario values sponsored and joint sponsored pension plan assets by adjusting to market value over a period of five years in accordance with Section PS 3250, paragraph .035 (i.e. at market related value).

- Other standard setters, both in the private sector (FASB, IFRS, UK private sector, and Part II (private enterprises) and III (not-for-profit) of the CPA Canada Handbook - Accounting) and in the public setter (IPSASB, GASB, and South Africa public sector), all require the valuation of plan assets on the statement of financial position at market value (however many of these standard setters including GASB and IPSASB as will be discussed later in this document do not require immediate recognition of the change in market value on the statement of operations). Exerts from the IPSASB's standard on EMPLOYEE BENEFITS, IPSAS 25 have been included in Appendix 1 to this Briefing Note. Reporting plan assets at market value is also consistent with the reporting by the pension plan in their stand-alone financial statements in accordance with Part IV (pension plans) of the CPA Canada Handbook - Accounting.

- Although market related value is not a basis of measurement in FINANCIAL STATEMENT CONCEPTS, Section PS 1000, it is however widely used throughout Canada (see Appendix 2 which summarizes the basis of valuation of plan assets by Canada and other provinces). Market related value recognizes the long-term nature of pension plans and the assets held to fund the future obligations. Recognizing short-term changes in the value of long-term plan assets on the statement of financial position is not an appropriate indicator of the financial resources available to the government over the long-term. Based on discussion with other senior governments across Canada, concern over valuing plan assets at market value largely relates to increased volatility that could result on the statement of operations which is beyond the government's control and its implication for fiscal policy decisions under balanced budget frameworks. Return on pension assets is partially beyond the control of the government. Although market value is the basis of valuing plan assets under other accounting standards, volatility resulting from changes in market value on the surplus/deficit is reduced by many standard setters (as addressed in the "Accounting for the Change in Plan Assets and Accrued Benefit Obligations" section of this document many standard setters have changes in market value being recorded in statements other than the statement of operations either on a permanent or deferred basis). Reporting plan assets at market value on the statement of financial position does not need to introduce volatility on the statement of operations as under the "no recognition option" discussed following although under the "deferred recognition option", recording of plan assets at market value rather than market related value will introduce more volatility on the statement of operation than under the status quo as one of the two currently existing smoothing options would be removed. Included in Appendix 3 is the impact a change from market related value to market value for OTPP (the Province's most significant pension plan) would have had on the Province's surplus/deficit since 2001. As illustrated in the Appendix, market value would have resulted in significant changes in the surplus/deficit of the Province relative to the use of market related value.

- In gauging the government's performance against plan, some might argue that market related values inherently provide a fairer picture of the government's performance against its approved plan. Since it is impossible to predict short term fluctuations in market values and pension assets are long-term in nature, the introduction of short-term paper gains and losses into the statement of operations would not provide more relevant and useful information to users. Governments have continued to express similar concerns to the Public Sector Accounting Standards Board in relation to the financial instruments standard. Of primary concern is the detrimental impact that such reporting would have on the statement of operations which continues to be the primary financial report for accountability and transparency reporting purposes to the legislature and the public.

- Allowing choice to value plan assets at market value or market related value on the statement of financial position is recommended as it provides flexibility for governments. It allows market value to be used which is an objective measure which best represents the value of the assets set aside to meet the pension obligations at a "point of time". Market value is easily understandable and is consistent with the market value of the plan assets as reported in the pension plan financial statements. Market related value however recognizes that plan assets are being held for the long-term and short-term changes in value are not as relevant. Information on the market value of plan assets will continue to be disclosed in the notes to the financial statements when plan assets are valued at market related value.

Components of the Change in Plan Assets

- Section PS 3250 is based on the view that the investment return on plan assets is made up of an expected return component and an unexpected return component. The expected return on plan assets is recognized immediately in the annual surplus/deficit. The difference between the actual return and the expected return (i.e., the unexpected return) on plan assets is a component of the actuarial gains and losses, and is recognized to surplus/deficit over the EARSL of the related employee group.

- The ITC considers whether the breakdown of the investment return between expected and unexpected return is appropriate or alternatively whether realized and unrealized gains/losses should be considered (i.e. should realized gains and losses be recognized immediately in the annual surplus/deficit and unrealized gains and losses be recognized over EARSL).

- Other employee benefit standards, similar to Section PS 3250, breakdown investment return between expected and unexpected return. It results in applying the same accounting for unexpected returns on the plan asset side as for experience adjustments on the benefit obligation side. Expected returns on plan assets can be budgeted and therefore volatility on the annual surplus/deficit is reduced.

- Alternatively, the decision to sell an investment and realize a gain or loss is not an indicator of how well a government is managing its pension plans. It is not an indicator of the return on plan assets. It is an investment decision most often made by the Board of the pension plan, beyond the control of the government. Because an investment gain is realized, does not mean the funds are available to be used to meet the government's general obligations. The funds are to be used for long-term pension obligations and will either be reinvested or used to pay out benefits to the plan members. Therefore treating the investment return on the basis of whether it is realized or unrealized is not appropriate for determining the change in plan assets on the statement of operations.

- The current expected and unexpected return breakdown is appropriate and recommended. While the estimate of expected return on plan assets is somewhat subjective, it does need to be supported based on management's best estimate. It needs to be appropriately supported based on prior historical returns and future projections. It is not arbitrarily determined by the government. It is audited by the government's auditor on an annual basis.

<u>Components of the Change in Accrued Benefit Obligations</u>

- Actuarial gains and losses include changes in actuarial assumptions and experience adjustments. The accounting for changes in actuarial assumptions and experience adjustments is consistent.

- The ITC indicates understanding the major drivers behind the changes in each key actuarial assumption would inform the assessment of whether the deferral provisions in these standards remain appropriate and justified. Changes in the value of accrued benefit obligations examined in the ITC are:

  1. experience adjustments (adjustments from actuarial assumptions to actual experience), and

  2. changes in actuarial assumptions broken down between:

     - demographic assumptions (which include assumptions regarding mortality, retirement, termination and benefit utilization),

     - discount rate assumptions (which will be addressed by PSAB in the next Invitation to Comment) and

     - other economic assumptions (which include assumptions regarding inflation, salary increases and medical inflation).

- Actuarial assumptions are estimates of future events and factors. Each key actuarial assumption is based on the government's best estimate of the future events that have an effect on the accrued benefit obligation. The assumptions take into account the expected long-term experience of the plan and the short-term forecast.

- Experience adjustments reflect the difference between actual experience and the previously established assumptions. Some argue that since experience adjustments and changes in actuarial assumptions both represent adjustments to previous accounting estimates, they should be accounted for in the same way. Others argue that experience adjustments are firmer numbers and therefore differ from changes in actuarial assumptions.

- While it is useful to understand the different components resulting in change in the accrued benefit obligation, treating separately these different components will not resulting in any meaningful improvement in the accountability of the government. It will only result in additional complexity for both financial statement preparers and users. Public interest will not be better served treating demographic assumptions differently than other economic assumptions for example. The components are assumptions long-term in nature associated with a long-term obligation. They reflect management's best estimate.

- While experience adjustments are firmer in the sense they relate to actual experience and prior assumptions, they still should be viewed in light of the long-term nature of a pension obligation. Assumptions are long-term in nature and will evolve over time. Adjustments one year may be offset in future years. Short-term recognition would not demonstrate better the long-term accountability of the government.

- It is therefore recommended changes in the value of accrued benefit obligations resulting from experience adjustments and changes in actuarial assumptions be accounted for consistently.

<u>Accounting for the change in Plan Assets and Accrued Benefit Obligations</u>

- There are currently two deferral provisions for the changes in market value of plan assets in Section PS 3250. The first being the adjustment to market value of plan assets over a five year period. The difference between market related value and expected return is then amortized over EARSL. The second is the difference between the actual return and the expected return (i.e., the unexpected return) on plan assets is a component of the actuarial gains and losses, and is recognized over the EARSL of the related employee group.

- Section PS 3250, paragraphs .061 and .062 and Section PS 3255, paragraph .24 all require actuarial gains and losses which includes experience adjustments and changes in actuarial assumptions to be amortized in a systematic and rational manner over the EARSL of the related employee group.

- The ITC discusses three alternatives for accounting for these changes in the value of plan assets and accrued benefit obligations currently being deferred and amortized:

  1. immediate recognition of the changes in annual surplus/deficit,

  2. no recognition of the changes in annual surplus/deficit either when they arise or in subsequent periods (referred to as the "no recycling option"), and

  3. deferred recognition which recognizes the changes in the annual surplus/deficit in subsequent periods (referred to as the "recycling option"). As mentioned, deferred recognition is the approach currently in Section PS 3250.

- Few standard setters have the unexpected return in market value of plan assets, changes in actuarial assumptions and experience adjustments being recorded directly in surplus/deficit. Of the 8 standard setters,

  1. Three standard setters recognize the changes immediately in surplus/deficit on the statement of operation.

     a. Part II (private enterprises) of the CPA Canada Handbook – Accounting (private sector),

    b. South Africa (public sector), and
    c. FASB as an option (private sector).

2. Four standard setters recognize the changes on a statement other than the statement of operations (for example, the statement of OCI or directly to net assets/equity as per IPSASB) and never recognize these gains/losses on the statement of operation (the "no recycle option").
    a. IPSASB (public sector),
    b. Part I (IFRS) and III (not-for-profit) of the CPA Canada Handbook – Accounting (private sector), and
    c. UK (private sector).
3. Two standard setters recognize the changes initially as either a deferral on the statement of financial position or on the statement of OCI, and then amortize these amounts to the statement of operation over a period of time (the "recycle option").
    a. GASB (public sector), and
    b. FASB as an option (private sector).

- Although some might say that immediate recognition of changes in the market value of plan assets, changes in actuarial assumptions and experience adjustments in annual surplus/deficit is conceptually sound as these changes meet the current definitions of revenues and expenses, this accounting would not however enhance the accountability of government to the public. It does not consider the long-term nature of a pension plan. Public interest is not better served by presenting year-to-year volatility (paper gains and losses) on the statement of operations under balanced budget frameworks. Financial reporting should reflect government decision making, not drive decision making. In fact, such accounting may result in policy makers deciding to take actions to reduce volatility by eliminating defined benefit pension plans, or as noted above, spending reported surpluses which do not exist but which merely result from temporary paper gains.
- The no recycling option removes all volatility from the statement of operations and therefore does not impact budget to actual comparisons or balanced budget legislation. This option however reduces the significance of the surplus/deficit and accumulated surplus/deficit balances. It will create a second measurement of performance for the government. Determining the bottom line of the government will not be as clear and obvious. IPSASB for example requires actuarial gains and losses to be recorded directly in net assets/equity.
- The recycling option is more of a balanced approach and a hybrid option which most closely resembles the status quo. Deferred recognition in the annual surplus/deficit recognizes the long-term nature of pension plans. Recognizing the changes over an extended period better reflects the long settlement period of the pension obligation and the long-term investment horizon of plan assets. Volatility in the annual surplus/deficit is reduced by smoothing out the effect of the changes and allowing short-term fluctuations to be offset. It allows the budgeting

process to incorporate future amortization of the changes in subsequent periods. GASB for example requires actuarial gains and losses to be amortized over EARSL.

- Regarding the recycling option, determining the alternatives available is made more difficult as PSAB is currently reviewing the reporting model through its Concepts Underlying Financial Performance project and continues to contemplate its financial instruments reporting standard for senior governments. Alternatives which are currently not allowed in the PSA Handbook (for example, reporting a deferral on the statement of financial position or reporting actuarial gains/losses on a statement other than the statement of operations) may or may not be acceptable and appropriate after the review of the conceptual framework is complete.

- It is recommended the deferred recognition option be maintained in accounting for changes in market value of plan assets, changes in actuarial assumptions and experience adjustments consistent with the requirements of some other standard setters (for example GASB). Deferred recognition best reflects the objective of government financial statements and the long-term nature of pension plans. It is a balanced approach that demonstrates the government's long-term accountability. It considers that financial reporting by governments can impact fiscal policy decisions as governments operate under balanced budget frameworks.

- Amortization of actuarial gains and losses over EARSL of the related employee group continues to be appropriate as it recognizes the long-term nature of pension plans and reflects the particular circumstances of each pension plan's employee group. It is the historical basis of amortization in the PSA Handbook and has been consistently applied by public sector pension plans across Canada. Building on this past practice, a choice could be introduced to allow a government to elect to amortize actuarial gains and losses over a shorter period as allowed by IPSAS. This election may be appropriate for example, when a pension plan is declining in membership or when the majority of plan members are currently retired.

<u>Other Questions in the ITC</u>

- PSAB also requested feedback on other matters that should be considered in its Employment Benefits Project. Ontario proposes to include reference to the following areas for consideration:

    1. Inconsistencies between the employment benefit standards and other standards in the PSA Handbook. For example, the deferral mechanisms in Section PS 3250 are inconsistent with the definitions of assets and liabilities and with the recognition guidance in FINANCIAL STATEMENT CONCEPTS, Section PS 1000. Such conceptual inconsistency makes it more difficult to apply the concepts in developing appropriate accounting policies when Section PS 3250 is not clear on a particular issue or different interpretations could be made.

    2. Application of the guidance on defined benefit plans to joint defined benefit plans, specifically whether to apply the standard's measurement guidance to the plan as a whole or to the government's portion of the plan.

3. How “minimum contributions” and “regardless of any surplus” should be interpreted in the context of the Asset Ceiling Test, including whether the surplus considered is a funding surplus or an accounting surplus.

4. Significant differences can exist between the financial position of a plan reported in its own financial statements and that reported in the financial statements of the government sponsor, largely because of different discount rates required by different accounting frameworks. This can be confusing to users trying to assess the underlying financial health of the plan and the assets and liabilities of the sponsor in respect of that plan. Significant differences can arise between the amounts reported for accounting purposes and those reported for funding purposes that can also be confusing to users when both valuations are made publicly available sometimes in the same document. PSAB's Employment Benefits Task Force should consider the concepts underlying the discount rate used in measuring pension obligations for accounting purposes, and whether additional disclosures regarding the purpose of the accounting valuation compared to a funding valuation may be helpful to users of government financial statements.

5. A review should be performed of the valuation allowance guidance in the standards to ensure the guidance is clear and complete.

6. A review should be performed of the guidance on accounting for multi-employer plans in the standards to ensure the guidance is clear and complete.

- PSAB also asked whether respondents would be interested in participating in future field tests, which may involve using actual benefit plan data to identify the financial implications of various alternatives. It is recommended the Province of Ontario participate in future field testing considered to be appropriate.

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Date: February 21, 2017

Appendix 1: Accounting requirements per IPSAS

EMPLOYEE BENEFITS, IPSAS 25
Recognition and Measurement – Present Value of Defined Benefit Obligations and Current Service Cost

Actuarial Gains and Losses

105. In measuring its defined benefit liability in accordance with paragraph 65, an entity shall, subject to paragraph 70, recognize a portion (as specified in paragraph 106) of its actuarial gains and losses as revenue if the net cumulative unrecognized actuarial gains and losses at the end of the previous reporting period exceeded the greater of:

(a) <u>10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and</u>
(b) <u>10% of the fair value of any plan assets at that date.</u>

These limits shall be calculated and applied separately for each defined benefit plan.

106. The portion of actuarial gains and losses to be recognized for each defined benefit plan is the excess determined in accordance with paragraph 105, <u>divided by the expected average remaining working lives of the employees participating in that plan. However, an entity may adopt any systematic method that results in faster recognition of actuarial gains and losses, provided that the same basis is applied to both gains and losses, and the basis is applied consistently from period to period.</u> An entity may apply such systematic methods to actuarial gains and losses even if they are within the limits specified in paragraph 105.

107. If, as permitted by paragraph 106, an entity adopts a policy of recognizing actuarial gains and losses in the period in which they occur, it may recognize them as a separate item directly in net assets/equity, in accordance with paragraphs 108 and 109, providing it does so for:

(a) All of its defined benefit plans; and
(b) All of its actuarial gains and losses.

108. <u>Actuarial gains and losses recognized directly in net assets/equity</u> as permitted by paragraph 107 shall be presented in the statement of changes in net assets/ equity in accordance with paragraph 118(b) of IPSAS 1.

Recognition and Measurement – Plan Assets

Fair Value of Plan Assets

118. <u>The fair value of any plan assets is deducted in determining the amount recognized in the statement of financial position under paragraph 65</u>. When no market price is available, the fair value of plan assets is estimated, for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).

Appendix 2: Valuation basis of pension plan assets by other jurisdictions in Canada

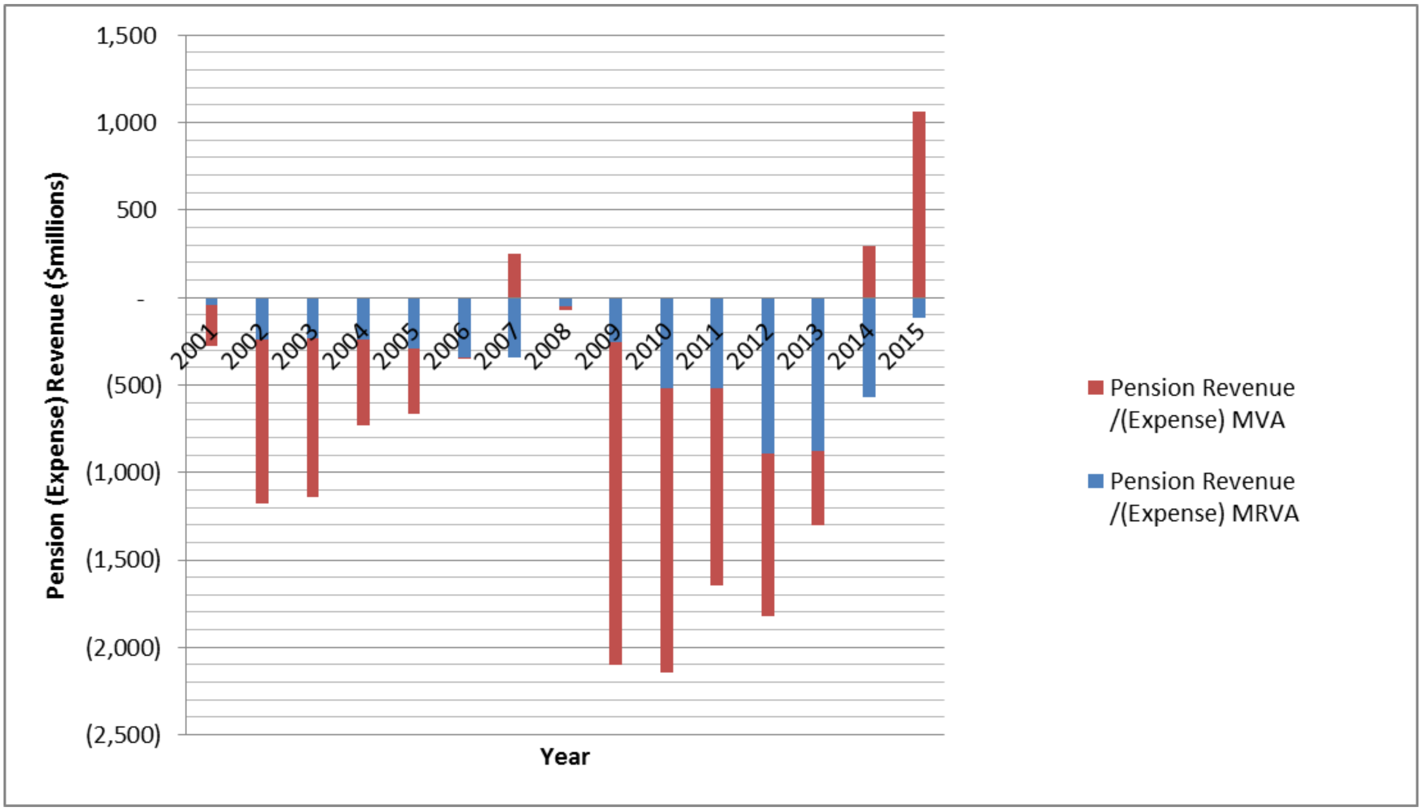
The valuation basis (i.e. market value or market related value) applied by other jurisdictions in Canada based on a review of their most recent public accounts is as follows:

Jurisdiction	**Accounting for pension assets**
Alberta – market value	Schedule 10 – Not indicated; Alberta has confirmed they use market value
British Columbia – market value	Note 17 (page 58) - Fund assets are based on market value at the date of actuarial valuation and extrapolated using actuarial growth assumptions as shown in the following table.
Canada – market and market related value	Note 7 v (b) (page 24) - Pension assets include investments held by the PSPIB that are valued at market related value; consolidated Crown corporations' investments, the majority of which are valued at fair value; and contributions receivable from employees for past service buy-back elections.
Manitoba – market related value	Note 1 (v) (2) (page 85) - The value of plan assets is determined using a moving average fair value method. Under this method, fair value is the underlying basis, with any excess (or shortfall) of investment returns over (or below) the expected long-term rate being amortized over a five year period.
Nova Scotia – market related value	Note 1 (page 78) - The net liability represents accrued employee benefits less the market related value of plan assets (if applicable) and the balance of unamortized experience gains and losses. The market related values are determined in a rational and systematic manner so as to recognize asset market value gains and losses over a five-year period.
Quebec – market related value	Note 1 (page 96) - The investments of the Retirement Plans Sinking Fund (RPSF) and specific pension funds and employee future benefit programs funds are valued at an adjusted market value. With this valuation method, the difference between the real return based on market value and the forecast return is amortized over five years.
Saskatchewan – market related value	Note 1 (page 48) - Pension fund assets are valued at market-related values.
Newfoundland and Labrador – market value	Note 7 (page 52) - Pension Fund Assets are valued at the market value at 31 March 2016.

New Brunswick – market related value	Note 1 f) (page 28) - Pension fund assets are valued at marked-related values.

Appendix 3: Impact on surplus/deficit of the Province of valuing plan assets of OTPP at market value versus market related value

The impact on surplus/deficit a change from market related value to market value for OTPP (the Province's most significant pension plan) would have had on the Province's surplus/deficit since 2001 is as follows:



As expected the surplus/deficit impact of OTPP is more extreme when plan assets are valued at market value rather than market related value.