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Analysis of Future years Pension Asset Ceiling Accounting Considerations for the Office of the Provincial Controller Division re: Province of Ontario Pension Plans

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Table of contents

Introduction

In preparation of the Province of Ontario Financial statements, the Office of the Provincial Controller Division (OPCD) has retained Deloitte to provide support in analyzing issues around pension accounting. The present document is prepared in relation to the assessment of the application of public sector accounting standards as related to the Ontario Pension Plans for future years' limits on the carrying amount of accrued benefit asset (referred as "asset ceiling" in this document).

The relevant accounting standards to use in our analysis is Public Sector Accounting Standard PS3250 on retirement benefits.

The document will cover the considerations in assessing future years' asset ceiling beyond the Ontario 2015-16 Financial statements.

We are available to discuss the content of this document.

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Section 1 – Relevant PS3250 paragraphs

Below are some extracts from the PS3250 that cover the calculation of the limit on carrying amount of accrued benefit asset (the asset ceiling test). The joint defined benefit provisions are included as they are relevant to the analysis and position taken for financial statement preparation for certain plans that are Jointly-Sponsored Pension Plans (JSPP) as per the Ontario legislation on pension. Note that the underlined portions are from us.

We have added a paragraph on gains and losses to support the illustration of the impact of an asset ceiling position (see Section 2).

Limit on the carrying amount of an accrued benefit asset

.050 *An accrued benefit asset should be presented on a government's statement of financial position net of any valuation allowance. <u>When a defined benefit plan gives rise to an accrued benefit asset, a government should recognize a valuation allowance for any excess of the adjusted benefit asset over the expected future benefit. A change in valuation allowance should be recognized in the statement of operations for the period in which the change occurs</u>.* [SEPT. 2001]

.051 A government with a defined benefit plan may have an accrued benefit asset for accounting purposes. An accrued benefit asset arises when the government's total contributions to the plan, including interest earned thereon, are greater than the retirement benefit expense recognized since the start of the plan. Contributions reflect the funding objectives of the plan. The benefit expense reflects the accounting objectives and may differ for a number of reasons, including the fact that actuarial gains and losses are deferred and amortized in future periods.

.052 A government may benefit from an accrued benefit asset either by <u>withdrawing surplus assets or by taking a contribution holiday or receiving a refund of contributions</u>. 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 a regulatory moratorium on pension surplus withdrawals or uncertainties as to a government's legal right to use a plan's accounting surplus.

.053 To determine the extent to which an accrued benefit asset may be impaired, the government first determines the adjusted benefit asset. <u>The adjusted benefit asset is the accrued benefit asset less net unamortized actuarial losses (determined on a basis using market value of assets)</u>.

.054 The adjusted benefit asset is then compared to the expected future benefit. <u>When the expected future benefit exceeds the adjusted benefit asset, the accrued benefit asset is not impaired and, accordingly, no valuation allowance is required.</u> The chart included as Appendix A to this Section is intended to set out the relationship between the various defined terms.

.055 The objective of the standard in paragraph PS 3250.050 is to <u>limit a government's accrued benefit asset to the amount it can realize in the future</u>. The <u>expected future benefit is a calculated amount representing the benefit a government expects to realize from a plan surplus</u>. An expected future benefit includes any withdrawable surplus or reduction in future contributions.

.056 A government determines its expected future benefit as the sum of:

a. the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
b. the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

.057 A government's expected future accruals for service for the current number of active employees are determined on a basis consistent with that used to determine its accrued benefit obligation. These expected future accruals for service, less required employee contributions and minimum contributions the government is required to make regardless of any surplus, are then discounted back to the current period to determine the present value. The interest rate used to calculate this present value is the expected rate of return on plan assets used to determine the benefit expense in the period.

.058 When administration expenses are paid by the plan and included in the normal cost calculation, a best estimate of the future administration expense is included in the expected future accruals for service. When administration expenses are paid by the plan and not included in the normal cost calculation, the rate of return on plan assets is adjusted to reflect the deduction of the administrative expenses.

.059 A key factor in determining a government's expected future benefit from a defined benefit plan with a plan surplus for accounting purposes is the ability of the government to withdraw assets from the plan. The expected future benefit includes amounts to which a government has a legally enforceable right of withdrawal. It excludes any withdrawable plan surplus a government is currently required, or intends, to allocate to employees. 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. 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.

Joint defined benefit plans

.079 Governments may participate jointly in defined benefit plans where the government shares the risks and rewards jointly with plan participants, represented by a sponsor or sponsors. Joint defined benefit plans are governed by a formal agreement between the sponsors, which establishes that the sponsors have shared control over the plan. A governing board is generally appointed by the joint sponsors with equal representation and a mutually agreed-upon chair.

.080 A government would consider the characteristics of the plan to determine whether it meets the definition of a joint defined benefit plan. In a joint defined benefit plan, funding contributions are shared mutually between the government and the plan members. The sponsors have control over decisions related to the administration of the plan and the level of benefits and contributions on an ongoing basis based on the terms of the contractual agreement. The sponsors share, on an equitable basis, the significant risks associated with the benefit plan. Risk would not be considered to be equitably shared in an arrangement where the government and the joint sponsors fund the plan equally but where the government retains the full risk of the accrued benefit obligation. If the government retains the residual risks it is unlikely that the plan meets the definition of a joint defined benefit plan.

.081 *When a government participates in a joint defined benefit plan, the government's risk is limited to its portion of the plan. The government should account for its portion of the plan in accordance with the standards for defined benefit plans.* [SEPT. 2001]

.082 A government may convert an existing defined benefit plan for which it is the sole sponsor to a joint defined benefit plan where the risks and benefits are shared. When converting to a joint plan, a government would consider whether there are any special accounting issues that arise, including whether the predecessor plan has been settled or partially settled and/or curtailed or partially curtailed. In assessing such issues a government would have regard to its specific circumstances and the terms of the joint defined benefit plan.

Actuarial gains and losses

.061 Actuarial gains and losses would be amortized over a reasonable future period because of their tentative nature and because further adjustments will likely be required in the future. A reasonable future period is the expected average remaining service life of the related employee group. Amortization may commence in the period following the determination of the adjustment. Actuarial gains and losses would be determined on a market value basis or a basis adjusted to market value, consistent with paragraph PS 3250.035.

Section 2 – Impact of asset ceiling

We have identified previously the key considerations that go into the determination of the inputs for the asset ceiling calculation and specifically the expected future benefit (EFB). These were covered in our analysis documents on the Province 2015-2016 financial statements in relation to Ontario Teachers' Pension Plan (OTPP) and Ontario Public Service Employees Union Pension Plan (OPSEU PP). In the present section, we cover the treatment of an asset ceiling impact and discuss the volatile nature of the financial statements when such ceiling applies. This will highlight the concerns that may arise if and when an asset ceiling would apply to one of the Province pension plans.

Impact of seet ceiling on annual expense

When an asset ceiling applies, a valuation allowance is created (PS3250.050). When there is an increase (reduction) in valuation allowance from year to year, the change is recognized as an expense (income) in the year of the change. Therefore, it has an immediate impact, no deferral mechanism.

To illustrate how this can be significant, we could have a situation where the asset return in the last month of a fiscal year is very good and creates or improves a surplus position. If the asset ceiling test indicates that a valuation allowance needs to be applied, the change in the last month could lead to an expense that was unexpected and that can be sizeable. Therefore, in any case of asset ceiling impact, the immediate recognition nature of an unexpected amount will affect the financial statements of the employer. We note that the outcome is also non-intuitive since the valuation allowance increase in this example creates an expense whereas the plan rather did experience gains through good asset returns. In years of bad news (ex losses on asset), the contrary would apply, leading to reduction in valuation allowance, creating an income, whereas the plan went through asset losses.

Mismatch of valuation allowance change and the treatment of gains and losses

To further illustrate the complication of asset ceiling under PS3250, we note that the elements that usually create the valuation allowance change in a year are usually treated in a much different manner. As illustrated in the paragraph above, valuation allowance can be created by an unexpected event that comes up late in the year, such as good asset return in the last month. This good news would create a gain generating or increasing a surplus. Under the PS3250.061, the good news (i.e the actuarial gains) must be deferred and amortized over future years, usually over what we call the expected average remaining service life of active employees (EARSL), starting with the year after the gains and losses occurrence.

As an illustration, if we assume a gain on asset return creating a valuation allowance of $3B and an EARSL of 15 years, we would have the following mismatch of recognition:

- an expense would be created in the current year for the $3B change in valuation allowance
- the gains would be deferred and amortized over the year 2 to 16 (15 years) as income at a rate of $3B / 15 years = $200M per year
- this leads to $3B expense in year 1 and $200M income for each years 2 to 16

This shows the drastic effect that an asset ceiling has on the timing recognition.

To further show the drastic effect, let's suppose that in year 2, we suffer asset return losses of the same $3B level that ends up reducing the surplus position and hence reducing the asset ceiling. We would get the opposite effect. In theory, we may expect that nothing happened as we just been through years of asset return volatility that cancelled out. But when we look in practice at the accounting results, we do get lots of variability. Combining the year 1 and year 2 experience:

- year 1: $3B expense
- year 2: $3B income + $200M income amortization = $3.2B income
- year 3 to year 16: $200M income amortization + $200M expense amortization = $0 net
- year 17: $200M expense amortization

So the effect over all 17 years do reflect the "theory" that the 2 years have cancelled out since the combination of all amounts is nil, but in practice, the mismatch leads to extreme changes over the years.

Most public companies apply IFRS accounting in Canada, and IAS19 in particular for retirement benefits. An old version of IAS19 that also had deferral and amortization of gains and losses, had provisions that would address such situation and "match" the recognition of gains and losses with the effect of valuation allowance. In our example:

- the valuation allowance change in the year creates a $3B expense
- the gains of $3B on asset that creates the change in valuation allowance would be reflected immediately in income
- the resulting effect for the year would be nil.

The old IAS19 standard did recognize that this was needed to address a particular situation. PS3250 does not include such provision and there is no option for using immediate recognition of gains and losses in this circumstance or other cases. This is one situation that the PS3250 does not specifically cover and that may be perceived as a flaw.

This provides insight on what may happen if and when a pension plan is affected by an asset ceiling test. It shows that any impact would lead to important mismatch and volatility under current PS3250.

Balanced budget and asset ceiling

The 2 elements above do show the complexity that arises in financial statements when asset ceiling applies under PS3250. This can bring significant volatility in results in unexpected manner and also lead to mismatch of results. This may even create difficulties in explaining why an expense (or income) is created in a year of good (or bad) news. This is non-intuitive and is directly related to the mismatch in timing recognition.

In a balanced budget environment, this is difficult to manage. As illustrated, an old version of IAS19 with a similar situation did have provisions to deal with this but PS3250 does not. By experience, we have seen the Quebec municipal Ministry provide the municipalities with an alternative to prepare a GAAP to fiscal financial results reconciliation that would address this situation. The idea of the mechanism basically leads to applying a similar approach of old IAS19 to the PS3250 accounting. On a GAAP basis the results need to be in line with PS3250 approach but under the fiscal basis used for balanced budget purposes, the mechanism of old IAS19 would be used and adjust for the timing mismatch. This approach requires that the employer maintains a dual accounting basis (GAAP and fiscal). If the Government is affected by asset ceiling for one of its sponsored pension plans, this approach might be analyzed to determine if it could be applied to alleviate the balanced budget situation.

Key parameters of the asset ceiling test – interepretation of minimum employer required contribution and the right to surplus

.056 A government determines its expected future benefit as the sum of:

a. the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
b. the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

We note that the EFB cannot be negative and hence any calculation of PS3250.056 would be at minimum of 0. There has been in recent years more questions around the meaning of the EFB definition and mostly around what the last part of PS3250.056 a) means. The terminology used of "minimum employer contribution required regardless of any surplus" has been discussed and there have been different views on what this represents.

One view (View 1) focus on whether there is a minimum employer contribution under the plan / legislation that is required even if a surplus would be present. For instance, a plan contribution could be defined as always being at least of 5% of salaries. In such circumstances, there would be a contribution requirement to a minimum level for every year even when surplus is present. If no such minimum exists and there is a possibility to get to 0% contribution, for instance in surplus position, then there would be no minimum contribution required "regardless of any surplus". This view leads to no reduction in the EFB calculation in cases where no minimum % contribution exists in the plan provisions.

A second view (View 2) is that minimum required contribution must at least consider the effect of the most recent funding valuation report. This report determines what contribution requirement applies to the current period of the valuation report and until a new report is completed. For instance, if the employer needs to contribute for the next 3 years a certain amount of contribution (service cost and special contribution for deficit), then this represents the minimum required employer contribution regardless of any surplus.

Another view (View 3) is a variant of View 2. Using the same funding valuation, it would use the period for which all special deficit constributions are scheduled rather than just the period until the next valuation report is required. As an example, if a schedule of special deficit contributions is defined for a 15-year period, than the 15-year service cost contribution and the 15-year deficit contribution would be assumed in the PS3250.056 a) calculation for minimum employer required contribution. In presence of a deficit in a funding valuation report, this view generally would reduce significantly the EFB value.

Finally, a more extreme view (View 4) could be to actually prepare detailed future projections of funding valuation results on either a deterministic calculation with identification of the actual year(s) when funding surplus would be present or a stochastic calculation to identify what is the probability of occurrence of funding surplus in future years and the outcome in those cases for contribution reduction/surplus withdrawal. Such an approach would need the inclusion of some many complex assumptions and the preparation of a high volume of calculations.

We have never seen in practice the use of View 4 under PS3250, while View 1 has been largely used historically. On the other hand, we note that View 2 and its View 3 variant have been recently observed as a possible emerging interpretation of the paragraph 3250.056.

Along with defining a view on this portion of the PS3250.056 definition, the Government also needs to identify if it has access to surplus in a plan above the contribution reduction, for instance through surplus withdrawal.

Section 3 – Future years considerations

We note that any limit that may apply on adjusted benefit asset would create volatility in results that may be difficult to address in balanced budget environment. We have explained under Section 2 the effect of this on the year expense and also the mismatch of treatment when this is created because of gains and losses. Change in valuation allowance is recognized in the year it occurs while the gains and losses that affect the ceiling test is amortized over EARSL. This might be perceived as a flaw of PS3250 that mismatches recognition. It also becomes difficult to explain since a gain on asset in last month of a year (good news) may end up creating an asset ceiling impact (expense – bad news) while the good news is amortized over future years. In perspective of working with balanced budget, this is difficult to handle. The Government may look at whether this situation that may occur to its sponsored plans could require some special approach to be applied for balanced budget purposes. We have provided an overview in Section 2 of an approach that has been taken by the Quebec municipal Ministry to address this situation in an environment of balanced budget for municipalities.

The Chartered Professional Accountants (CPA) is going through a review of PS3250 and the review will cover the deferral of gains and losses. Depending on the outcome of the review, the mismatch situation may prevail or not in a revised PS3250 standard. There will be an opportunity to comment on a CPA Invitation to comment (ITC) in 2016. This mismatch should be mentioned as a situation that would need to be covered in the PS3250 review to ensure consistency of treatment. Depending on the specific Ontario plan situations for asset ceiling, the situation could either be worked through analyzing the options (as per the Quebec example above) or waiting for the outcome of the CPA work.

That being said, it is very important that the accounting obligation valuation represents what the accounting defines as the best estimate. The selection of assumptions to prepare the accounting valuation is therefore significant to ensure that the surplus calculated is acceptable. The presumption is that those assumptions are selected by the Government as best estimates and therefore the surplus determined is a realistic value of what benefit the Government may realize in the future through surplus withdrawal/contribution reduction.

Also, should the characteristics of a pension plan or its Funding policy parameters change and affect the access of the Government to the surplus, the conclusion reached in one year for the asset ceiling test may need to be revised in the ensuing years.

For the various plans that are accounted for in the Ontario Financial statements, the following elements will need to be defined / clarified:

- identify all the plans that fall under the Ontario Financial statements and extracing the plan information for financial position, balance sheet asset (liability), service cost
- identify if the plan is using a market-related value of assets for accounting and if so how it differs from market value
- identify the nature of the plan, besides the OTPP and OPSEU PP that were covered in separate analysis, we see in the Ontario pension legislation that other plans likely fall in the JSPP category (HOOPS, OMERS, CAAT) but there are likely other plans that are rather treated as having a balance cost to the employer and not a joint sharing
- determine if the plan is still opened or closed to new/all employees

- determine how to treat the asset ceiling test when the plan is not based on Joint defined benefit accounting
- identify if the Government has a right to the surplus through contribution reduction and through surplus withdrawal and to what extent
- determine if the Government has an obligation to contribute a minimum level of contribution to the plan and specifically determine what is the view for minimum required Government contribution considered for Expected Future benefit (EFB) calculation (Views 1 to 4 described in Section 2)
- on an ongoing basis, any change to the plan or funding policy during the year would need to be identified to determine if it affects the elements defined in the asset ceiling test
- consider the CPA work on Public sector accounting standards and identify what might be the possible changes affecting the asset ceiling calculations
- depending on the outcome of the asset ceiling situation of all plans, determine if a possible approach could be set up from a fiscal perspective to manage the volatility in the context of balanced budget or if the Government will wait for the CPA work to conclude on gains and losses

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