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Additional information on asset ceiling calculation

Dear Cindy,

This document is in response to the request received from Nadine Petsche on 6 June 2017 to provide our advice to you regarding the request from the Office of the Auditor General of Ontario (AG). In particular, we understand that you would like some additional advice related to the asset ceiling calculation we performed, and the AG's ask to prepare and provide a calculation of the asset ceiling test using the "perpetuity assumption" for both Service Cost and Contributions for each significant pension plan.

This document provides this additional advice and is intended to inform and support OPCD in forming its opinion on appropriate accounting related to OTPP and OPSEUPP in the Province's financial statements. This document does not constitute an accounting opinion and should not be used as such. This document is intended for OPCD's use only. Please inform us in writing of any parties outside of the OPCD that you would like to share this document with before it is shared.

Asset ceiling test for OTPP and OPSEUPP

As you know, we have completed our analysis and calculation of the asset ceiling tests for OTPP and OPSEUPP that was provided to your office via two draft documents dated 16 May 2017. [1]

The asset ceiling test analysis and calculation we prepared for you showed that there is no impact on the asset ceiling test, and that there is no valuation allowance required in respect of OTPP and OPSEUPP. This is because the expected future benefit exceeds the value of any contributions that the plan sponsors must make regardless of any contributions [PS 3250.50-59]. The following table summarizes the results:

As at 31 March 2017	OTPP	OPSEUPP
1. Adjusted benefit asset (PS 3250.053)	51.8B	2.30B
2. Expected future benefit (PS 3250.056)		
a. Present value of service cost (PS 3250.057)	100.1B	13.88B
b. Present value of minimum contribution requirement, regardless of any surplus (PS 3250.056a)	(0.0)B	(0.0)B
c. Expected future benefit [(2.a) – (2.b)]	100.1B	13.88B
3. Valuation allowance (PS 3250.054) [max (0, (1)-(2.c)]	0.0B	0.00B

[1] Those documents are in draft form to allow for a final update once the discussions on year-end adjustments are complete. However, our conclusions as they relate to the asset ceiling calculation, and in particular to the "perpetuity assumption" are not affected by any changes that may be made to that year-end adjustment process.]

4.	Accrued benefit assets	26.9B	1.95B
5.	Valuation allowance	(0.0)B	(0.0)B
6.	Accrued benefit assets, net of valuation allowance (PS3250.050) [(4) – (5)]	26.9B	1.95B
7.	Province's portion of accrued benefit asset	50%	50%
8.	Province's portion of accrued benefit asset [(6) x (7)]	13.5B	n/a
9.	Province's portion of accrued benefit asset, reflecting unused RSF in excess of OPSEU's RSF[2]	n/a	1.02B

The above analysis does not reflect any year-end adjustments to the balance sheet position by OPCD.

Since the plans have significant future service cost accruals, the present value of which exceeds the current surplus, it is reasonable to conclude that the government can benefit from the entire surplus asset and therefore can recognize it on the balance sheet under PSAS.

In the above analysis we have considered, in perpetuity, any minimum contributions that the plan sponsors (Province and the employee unions) are required to make regardless of any surplus, in accordance with 3250.56. As there are no minimum contributions that are required to be made regardless of any surplus for either OTPP or OPSEUPP, this present value in perpetuity is nil.

For ease of reference, we will refer to the "minimum contributions the government is required to make regardless of any surplus" in PS 3250.56(a) as "MCRS" in the remainder of this document.

For greater clarity, we have not included the currently required funding contributions, in perpetuity or otherwise, into the asset ceiling test calculation as it is our understanding that this would not be in compliance with PSAS. These contributions are currently in place to fund deficits, and to provide for current service costs for which there are no assets currently in place. However, there is no requirement for these contributions to continue regardless of any possible surplus in the plan (ie. they are not MCRS). When there is surplus, these contributions can be reduced, or a contribution holiday can be put in place, as permitted by the legislation and plan documents related to OTPP and OPSEUPP. There is no requirement in OTPP and OPSEUPP to maintain a minimum level of contributions regardless of any surplus that may exist. Because of this, for the purposes of the calculations we prepared for you we determined that there are no MCRS as per 3250.56(a) that would need to be included in the asset ceiling calculation for these plans.

Further detail on these points, and additional matters for your consideration, are contained in the remainder of this document.

[2] Based on the Rate Stabilization Fund ("RSF") allocation as at 31 December 2014, the most recent funding valuation date, OPSEU has utilized their RSF $0.09B more than the Province. The Province portion, reflecting RSF allocation is determined as 50% x (1.95B-0.09B) +0.09B

“Perpetuity Assumption” and MCRS considerations

PSAS guidance

PS 3250.56 states **“***a government determines its expected future benefit 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”.*

The purpose of the asset ceiling test is to ensure that the financial statements do not include any assets that the government cannot expect to benefit form. A pension asset may have a value if it can be refunded from the pension plan to the government (PS 3250.56(b) above), or it may have value if it can be used to reduce future contributions that otherwise might need to be made (PS 3250.56(a)). We understand based on the pension legislation and plan documents, and our discussions with the OPCD, that it would be difficult or impossible for the plan sponsors to withdraw assets from either OTPP or OPSEUPP. Thus, the only way the plan sponsors may expect to benefit from any surplus assets in the plan is via future contribution reductions or holidays. The asset ceiling test is used to determine the amount of assets that can be used in this way, and hence the amount of assets that can therefore be recognized on the balance sheet.

As PS 3250.57 states, the test is performed by first determining the total present value of all future service costs. This present value represents the total cost of all benefits that will be earned by plan members in the future. This cost can either be met through future contributions, or if there is a surplus in the plan and the legislation and the plan terms permit, from that surplus. This is the maximum amount of surplus that could be used to offset future cost, and therefore the maximum pension asset that the government could recognize on its balance sheet. Reducing this maximum value would be any contributions that the government/plan sponsors are required to make regardless of any surplus. The logic here is that if the plan sponsors must continue contributing to the plan even if the plan was in surplus (ie. “regardless of any surplus”), then the government’s benefit from that surplus is reduced. The reduction in the asset equals to the present value of any such MCRS.

As discussed in detail in the Pension Expert Panel report, neither OTPP nor OPSEUPP have any requirements that would compel the plan sponsors to continue to contribute into these plans, even if the plans were in surplus. The contribution levels for both plans are negotiated directly by the plan sponsors who make them, and the funding level of the plan is a key determining factor in those negotiations, allowing the plan sponsors to increase or decrease contributions as they deem appropriate, and reducing or eliminating any contributions that may not be needed if the plan is already in a surplus position. This is in contrast to other plans, some of which have requirements to continue contributing regardless of any surplus. For example, the public service pension plan in New Brunswick has a minimum contribution level of 8% of payroll that cannot be reduced. Therefore, this plan would have MCRS (ie. 8% of payroll) that must be used in the asset ceiling test. In our understanding, it is this requirement that results in full valuation allowance and no pension asset being recognized in New Brunswick government’s financial statements.

Canadian practice

The MCRS language contained in PS3250.56 mirrors the same language in other current and former Canadian standards:

- Part II – Accounting Standards for Private Enterprises (where 3462.69 has the same reference to MCRS)
- Part III – Accounting Standards for Not-for-Profit Organizations (which incorporates 3462 provisions)
- Part V – pre-changeover CICA 3461 (where 3461.105 has the same reference to MCRS)

Under all these standards, in our experience, the Canadian practice has been to interpret the “perpetuity assumption” and MCRS as we describe in this document, and in the same manner as we applied it in our calculations shared with you on 16 May 2017 for OTPP and OPSEUPP. We have never seen MCRS interpreted in a way that would treat any and all contributions as MCRS; to do so would be more in line with the type of analysis that would need to be carried out under IFRIC 14. However, IFRIC 14 only refers to minimum funding requirements, and does not qualify them as the requirements that exist “regardless of any surplus”. This is the main reason that adoption of IFRIC 14 in Canada caused significant concern and discussion, that highlighted differences between IFRIC 14 requirements and the existing Canadian practice, with the “regardless of any surplus” qualifier being one of the key difference areas. In the non-IFRIC 14 context, the only instances where the “regardless of any surplus” qualifier applied, and affected the asset ceiling tests, were those where the employer had committed to a minimum contribution level that was not dependent on the funding status of the plan (eg. a commitment to match employee contributions of 4% of earnings).

Expert panel report

The Pension Asset Expert Advisory Panel report (“Report”) stated the following:

> “*A question arises as to whether the surplus that is contemplated in the phrase “regardless of any surplus” is an accounting surplus or a funding surplus. The Panel understands that in practice actuaries interpret this to be a funding surplus. If any contributions are required even when there is a funding surplus, these would be “minimum contributions the government is required to make regardless of any surplus”. This interpretation rests on the logic that funding contributions, including any minimum funding requirements, are driven by funding surpluses/deficits, and not accounting surpluses/deficits.”*

The Report also outlines in detail how the funding contributions are set for OTPP and OPSEUPP. It concludes that there are no contributions that would be required to continue even if the plans were in a surplus position.

The recommendations of the Report are therefore consistent with the approach we describe in this document, and with our asset ceiling calculations shared with you on 16 May 2017 for OTPP and OPSEUPP.

Purpose of Asset Ceiling under PSAS

In our view, the purpose of the asset ceiling tests under PSAS, as well as other standards, is to ensure that only those assets that the government can expect to benefit from should be included on the balance sheet. Any assets that the government cannot expect to be able to use should be written down via a valuation allowance.

It is important to note that the true ultimate cost of a pension promise (ie. the total of all benefits paid to pensioners over time) does not depend on the measurement of that cost. In other words, both the funding valuations and the accounting valuations are attempting to measure the same real costs, each for a different depend on how we measure it. Accounting and funding valuations merely allocate those costs to periods of time. With that in mind, it is reasonable to expect that in some periods the surplus or deficit will be measured differently under the accounting standards vs. funding valuations. Nevertheless, the economic question that the asset ceiling is attempting to address is if at any point there may be a surplus in the plan that for some reason could not be used either by reducing contributions or withdrawing assets. Put another way, there should only be an asset impairment if the plan is both overfunded, and the contributions could not be reduced in order to use up excess assets. While this may be the case for some plans, we understand that this is not the case for OTPP and OPSEUPP.

cc: Karen Hughes, Associate Deputy Minister
Helen Angus, Deputy Minister
Nadine Petsche, Director, Accounting Policy and Financial Reporting Branch