DRAFT FOR DISCUSSION PURPOSES ONLY: FACTS ARE SUBJECT TO WRITTEN CONFIRMATION AND MAY CHANGE; THEREFORE, ALL TENTATIVE CONCLUSIONS AND OBSERVATIONS HEREIN ARE ALSO SUBJECT TO CHANGE; THIS DRAFT IS ALSO SUBJECT TO FINAL REVIEW AND ALL PARTS OF IT ARE SUBJECT TO CHANGE THROUGH THIS PROCESS

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September xx, 2016

Private and confidential

Ms. Karen Hughes
Associate Deputy Minister,
Treasury Board Secretariat,
7 Queen's Park Crescent
Toronto, Ontario M7A 1Y7

Dear Ms. Hughes:

We have been engaged to report on the appropriate application of certain aspects of Canadian public sector accounting standards to the recognition of the accrued benefit asset (also referred to in this report as the pension asset or the asset) related to the Ontario Teachers' Pension Plan (OTPP) in the Province of Ontario's accounts as at March 31, 2016. This report is being issued to the Associate Deputy Minister of Treasury Board Secretariat of the Government of Ontario. Our engagement has been conducted in accordance with Canadian generally accepted standards for such engagements**.**

It should be noted that the responsibility for the proper accounting treatment rests with the preparers of the financial statements, who should consult with their incumbent auditor. Our judgment on the appropriate application of Canadian public sector accounting standards for the specific issue being discussed is based on the facts, circumstances and assumptions provided to us. Should the facts, circumstances or assumptions differ, our conclusion may change.

Statement of Facts and Assumptions (NTD: these facts and assumptions may change, possibly resulting in significant changes to any all content in this draft letter.)

It should be noted that the following background and facts represent a fairly high level summary of the situation and represent those facts that we considered important in reaching our opinion. They do not purport to be a complete representation of all of the terms of the OTPP or the agreements between the

Commented [CV1]: Nadine – is this correct?
The original SOW (July 21) referenced only the President of TB, and the Amendment Letter heading also mentions President of TB. The original SOW acknowledges that the vendor will 'work with OPCD', and the vendor has added specific reference to OPCD in the first para of the amendment letter.
MC: Revised but open to further suggestions.

CV – My only thought is that Karen Hughes is neither the President of the Treasury Board (that is Minister Sandals) nor is she part of OPCD (she is the Associate DM of the Ontario Treasury Board into which OPCD reports). Nadine – need your knowledge/experience on this one.
Addressed – had already followed up on this with Karen. She is aware. Definitely wrong to reference an elected official, and she signed off on the amendment letter so we're all good here.

government and the Ontario Teachers' Federation. Management has acknowledged their agreement with this summary.

"The (Ontario Teachers') pension plan is jointly sponsored by the Ontario government, through the Minister of Education, and the executive of the Ontario Teachers' Federation (OTF). The OTF represents teachers, while the government represents employers.

OTF and the government are equally responsible for ensuring the pension plan has enough money to meet its long-term pension obligations. In addition, they appoint experienced, professional experts to the pension plan's Board.

Through a six-member Partners' Committee, the sponsors jointly:

- Set benefit levels
- Establish the contribution rate paid by working teachers (which is matched by the Ontario government and other designated employers)
- Decide how to address funding shortfalls or use surplus funds when they arise"

(Source: https://www.otpp.com/corporate/plan-governance)

The governing and other documents that management believes is relevant to an accounting analysis are as follows:

- Teachers' Pension Act (TPA)
- Partners' Agreement
- Funding Management Policy (FMP)

The following facts and assumptions have been accepted without further analysis:

- The actuarial and other assumptions that factored into the valuation used for accounting purposes, before consideration of any valuation allowance, are appropriate and meet the requirements of S. 3250.
- As at March 31, 2016, the adjusted benefit asset is $10.1B being equal to the accrued benefit asset less net unamortized actuarial losses before the consideration of any valuation allowance.
- The Plan's most recent preliminary funding valuation reported a surplus of $13.2 billion as at January 1, 2016, as reported on the OTPP website.
- The OTPP meets the definition of a Joint Defined Benefit plan under PS 3250 and the Province has historically recorded 50% of the plan on its financial statements.

Relevant Extracts from the TPA

Section 5 (1.1) of the TPA states that the total amount of contributions payable by the Minister of Education and the employers who contribute under the pension plan in respect of any year shall not exceed the amount of contributions payable by or on behalf of active plan members in respect of credited service for that year. There can be instances where contributions would not be equal between the sponsors, such as the government's payments in connection with forgone inflation adjustments and the additional contributions related to the 2008 filing agreement (1.1%) (Section 5 (8)).

Section 10 of the TPA provides that the Minister of Education and the executive of OTF may enter into an agreement that provides for, among other things, the joint management of the Plan and the sharing of entitlement to gains or surplus under the plan and of liability for deficiencies in the pension fund.

Pursuant to Section 10 of the TPA, the Minister of Education and the OTF (collectively the Partners) have entered into an agreement for the management of the Plan (Partners' Agreement), to which is appended a Funding Management Policy (FMP) that is deemed to form part of the agreement.[1] The FMP provides a framework for the funding of the Plan and how deficits and surpluses will be addressed. The Partners can deviate from the FMP by agreement.

Relevant Extracts from the Partners' Agreement

The Partners' Agreement is between the Province of Ontario and the OTF and sets out the formal relationship between the Partners in sponsoring the OTPP. Paragraph 8 of the Partnership Agreement states that the Partners will be responsible for designing the plan structure, setting the benefits of the plan, developing new policy, deciding what the contribution rate will be, what the funding levels, margins and contingency reserves will be, making changes to the plan, this agreement or other plan documents, deciding whether or not to file a valuation more frequently than required by the *Pension Benefits Act,* appointing the OTTP Board, and defining the role of the Board.

Paragraph 74 requires negotiation in good faith regarding changes to the plan that flow from a valuation that is to be filed with the regulators every three years.

Paragraph 75 of the Partners' Agreement requires the Partners to advise the Board of OTPP of what changes affecting benefits and contribution rates they are proposing so that the Board can provide cost estimates and comments on the administrative impact of the changes to both partners as soon as possible.

If the partners cannot agree on the changes required to the plan, a mediator is appointed to assist the Partners in coming up with an agreement. The mediator is responsible for submitting a report to the partners on his or her views on the positions of the partners and provide a recommendation to the Partners. If the partners do not accept the mediator's report, the arbitration process will begin and an arbitration board will be appointed. The board will consist of 3 people, with each partner selecting one representative and two appointees will select the final member who is an umpire. Paragraph 94 of the Partners' Agreement indicates that the report created by the arbitration board will be implemented. Paragraph 92 sets some parameters for the arbitration, including part (c), which sets out that the parameters that the award of the arbitration will provide that the contributions from the Minister and employers be equal to those of the members.

In addition to the clauses identified above, the Partners' Agreement has an appendix called the Funding Management Policy which sets out the Partners' responsibilities in making funding decisions and surplus allocation regarding the plan.

Relevant Extracts from the FMP

The FMP is an appendix to the Partners' Agreement that speaks to how the plan should be funded and how surpluses should be utilized by both parties. The protocol for the use of surplus under the OTPP is detailed in the FMP adopted by the Ontario Government and OTF as sponsors of the OTPP.

[1] Partners' Agreement, section 110.

The FMP sets out a complex series of considerations surrounding funding management and the use of any excess of assets over liabilities. The FMP sets out a number of "funding zones", depending on the level of funding in the plan. The following three are most relevant to addressing surpluses:

i) Restoration zone (Article 3 of the FMP) allows for surplus to be utilized to "restore" foregone indexation and then to either increase benefits to the "run-rate benefit" level (i.e., the long-term target level) or to lower contributions (or a combination of these two options) (Section 3.06(e)).

ii) Temporary improvement zone (Article 4 of the FMP) is the zone where contributions can be temporarily reduced, a surplus distribution can be made on a temporary basis and/or benefits can be temporarily improved (as long as it does not create a long term cost) (Section 4.05).

iii) Permanent improvement zone is where the plan is essentially fully funded and has the funding security desired to support permanent changes. Article V (Permanent Improvements) of the FMP provides for permanent actions that can be taken when Plan assets exceed current liabilities by more than 10% of current liabilities. In this regard Section 5.05 provides for actions that can be taken in respect of the amount that assets exceed current liabilities. Such actions can include changes to current benefits, current contributions, or both.

The ability to reduce contributions or increase benefits through the temporary or permanent improvement zone are subject to ensuring that the requirements of 3.06 in the restoration zone are met. Article VIII of the FMP sets out that the parties must agree to any changes arising out of FMP decisions. For filing valuations, if the Partners are unable to agree upon the mediation process set out in the Partners' Agreement, the arbitration process outlined in the Partners' Agreement will be followed. For valuations that are not filed, either party can decide not to negotiate.

It is our understanding that the plan is currently in the Restoration Zone. We understand that contributions to the OTPP currently include a 1.1% special contribution on all earnings and that the Restoration Contribution Reduction under Section 3.06(e) would, if agreed to by both partners, permit this special contribution to be eliminated.

If the plan gets to either the temporary improvement zone or the permanent improvement zone, section 4.06 and subsection 5.05(b) of the FMP provide that a benefit improvement can only occur if the Partners have entered into a written agreement governing the manner in which the contribution by the government and other employers may be adjusted to offset any surplus distribution or benefit improvement (temporary or permanent) to be granted.

History of Surplus

The FMP was not established until 2003. The following is a summary of the history of how deficits and surpluses were treated before the FMP and post the FMP (on a funding valuation basis).

Valuation Date	**Surplus/(Deficit)**	**OTF**	**Ontario Government**	**Surplus Remaining**
1990	$(7.8 billion) unfunded liability	Increased contributions by 1% to 8.9%	Agreed to make a series of special payments to eliminate the unfunded liability and match increased contributions	Special payments considered an asset bringing the plan to a $0 surplus

Valuation Date	Surplus/(Deficit)	OTF	Ontario Government	Surplus Remaining
1993	$1.5 billion	$325 million to offset social contract days	Eliminated special payments for $1.2 billion saving	$0
1996	$0.7 billion	$0.6 billion for benefit improvements and RCA contributions	N/A	$0.1 billion
1998	$6.8 billion	$2.2 billion for benefit improvements	$4.6 billion to reduce the value of remaining special payments	$0
1999	$3.5 billion	N/A	$3.5 billion to reduce the value of remaining special payments	$0
2001	$6.8 billion	$6.2 billion for benefit improvements	N/A	$0.6 billion
2002	$1.9 billion	Sponsors agreed not to make any changes to benefits or contributions		$1.9 billion
Total		**$9.3 Billion**	**$9.3 Billion**	

* Source: Ontario Teachers' Pension Plan Board "Report on Funding" (April 2002)

Year	Valuation Status and Key Decisions
2003	$1.5 billion surplus; no changes to benefits or contribution levels. Funding Management Policy adopted by plan sponsors.
2005	A preliminary $6.1 billion shortfall was resolved, leaving plan with a $0.1 billion surplus. Shortfall resolved with special contribution rate increases, totaling 3.1% of base earnings by 2009 for teachers, the Ontario government and other employers. OTF used the $76 million contingency reserve set aside in 2001 to reduce contribution rate increases for members in 2008.
2008	A preliminary $12.7 billion shortfall was resolved with the introduction of conditional inflation protection for pension benefits earned after 2009 and an increase in the basic contribution rate for members and the government to 9% from 8%. Employers agree to make special payments equal to any annual pension increases retirees forgo to a maximum of 50% missed inflation.
2009	A preliminary $2.5 billion shortfall was resolved primarily by assuming a slightly higher long-term rate of return on investments: yield on real-return bonds plus 1.5%, versus real-return bonds plus 1.4%. Other minor changes made to assumptions to reflect recent plan experience.
2011	A preliminary $17.2 billion shortfall was resolved with a 1.1% contribution rate increase (phased in over three years), slightly smaller annual cost-of-living increases for teachers who retired after 2009, and recognition of current contribution rate as the permanent base rate.

Year	Valuation Status and Key Decisions
2012	$9.6 billion preliminary shortfall adjusted to reflect changes in mortality assumptions and impact of two-year freeze on teachers' salaries. 2012 shortfall resolved by making inflation protection for pension credit earned after 2013 fully conditional on plan's funded status and providing slightly smaller pension increases, beginning in 2014, for members who retired after 2009. These changes enabled the plan to assume a slightly higher discount rate. The changes left the plan with a $200 million surplus at Jan. 1, 2012.
2014	$5.1 billion preliminary funding surplus used to boost pensions of members who retired after 2009 to the level they would have been at if full inflation protection had been provided each year since they retired. The surplus funds were also used to raise conditional inflation protection to 60% of the increase in the cost of living for the portion of retirees' pensions earned after 2009. Both changes are effective with January 2015 pension payments.
2015	Some of the $6.8 billion preliminary funding surplus was used to boost pensions of members who retired after 2009 to the level they would have been at if full inflation protection had been provided on January 1, 2015. The surplus funds were also used to raise conditional inflation protection for pension credit earned after 2009 to 70% from 60% of the increase in the cost of living. Both changes were effective January 2016. In addition, some surplus funds were reserved to help facilitate stability in contribution and benefit levels should a future funding valuation show a decline in assets or increase in pension costs.
2016	Some of the $13.2 billion funding surplus will be used to boost pensions of members who retired after 2009 to the level they would have been at if full inflation protection had been provided on January 1, 2016. The surplus funds will also be used to raise conditional inflation protection for pension credit earned after 2009 to 90% from 70% of the increase in the cost of living. Both changes will be effective January 2017. Some funds will also be reserved to increase the stability in contribution and benefit levels, should future valuations show a decline in asset value or an increase in pension costs.

* Source: Ontario Teachers' Pension Plan, "Key Funding Decisions Since 1990" adapted for September 14, 2016 announcement.

Application of Accounting Principles

Specifically, our report addresses the following questions:

1. Is it necessary for a government to have a legally enforceable right to reduce future contributions in order to recognize a pension asset under PS 3250?

2. What is the role of legal uncertainty in assessing the government's expectation of future benefit from a pension asset?

Commented [NP2]: The value of the pension asset?

Our views in this report are confined to these two questions and do not extend to any earlier reports provided by Deloitte on this topic or to any other analysis that may have been presented in draft or in a more informal manner.

Authoritative Literature

In our analysis, we considered the pronouncements and guidance in Section 3250 of the CPA Public Sector Accounting Standards Handbook. What we considered to be the most relevant passages from PS 3250 are reproduced below:

> **The objectives of funding and accounting**
>
> .008 Determining whether a retirement benefit plan should be funded and the amount to be funded each period is a financial management matter. The funding objective is to determine an acceptable policy for financing the estimated ultimate cost of a benefit plan. An actuarial valuation for funding purposes is performed to calculate the contributions required to secure the benefits promised.
>
> .009 The accounting objective is to measure and report the obligation for employee retirement benefits and to attribute the costs of those benefits to the periods in which the related services are rendered. To meet that objective, a method is needed to determine the amount of the obligation for retirement benefits outstanding, which represents the liability at the financial statement date, and the value of the benefits employees earned during the period, which represents the expense of that period. Accordingly, it is necessary to develop accounting estimates of liabilities for retirement benefits and expenses using an actuarial cost method and actuarial assumptions that ensure essential information required for fair presentation of financial condition and results of operations can be reported in government financial statements.
>
> .010 Because the objectives of determining the most appropriate funding policy are not necessarily the same as those of determining the most appropriate accounting method, the liability for accounting purposes may not be the same as the amount due but not yet funded at the financial statement date according to the funding plan. In addition, the retirement benefit expense of the period for accounting purposes may not be the same as the contribution computed in the period for funding purposes.
>
> **Actuarial Assumptions**
>
> .042 Actuarial assumptions should be based on the government's best estimates of expected long-term experience and short-term forecasts. [SEPT. 2001]
>
> **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.

Disclosure

.083 The notes and schedules integral to the financial statements would disclose the methods and judgments applied in accounting for accrued benefit obligations and expenses. Full disclosure is particularly important for retirement obligations because the measurements depend heavily upon judgments rather than objective evidence.

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. 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.* [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 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 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 which is the accrued benefit asset less net unamortized actuarial losses (determined on a basis using market value of assets).

.054 The adjusted benefit asset is then compared to the expected future benefit . When the expected future benefit exceeds the adjusted benefit asset, the accrued benefit asset is not impaired and, accordingly, no valuation allowance is required. 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 limit a government's accrued benefit asset to the amount it can realize in the future. The expected future benefit is a calculated amount representing the benefit a government expects to realize from a plan surplus. 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.

We also considered the following definitions as set out in the glossary of PS 3250:

- The **expected future benefit** is a calculated amount representing the benefit a government expects to realize from a plan surplus. An expected future benefit includes any withdrawable surplus or reduction in future contributions. 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.
- A **joint defined benefit plan** is a contractual arrangement between the government and another sponsor or sponsors representing plan participants that has all of the following characteristics:
  (a) the sponsors co-operate toward achieving the significant clearly defined common goal of providing retirement benefits in exchange for services rendered by the employees;
  (b) funding contributions are shared mutually between the government and the plan members, represented by the non-government sponsor;
  (c) the sponsors share control of decisions related to the administration of the retirement benefit plan and to the level of benefits and contributions on an ongoing basis; and
  (d) the significant risks associated with the retirement benefit plan are shared on an equitable basis between the government and the plan members, represented by the non-government sponsor.

The contractual arrangement establishes that the sponsors have shared control over the retirement benefit plan, and ensures that neither party is in a position to control the plan unilaterally. Nevertheless, overall, there must be an equitable relationship between the funding by the government of the retirement benefit plan, the extent of control it is able to exercise over the plan and the risks and benefits that accrue to the government from the plan.

We also considered the following guidance from PS 1150:

DEFINITIONS
.03(c) Primary sources of GAAP are, in descending order of authority:
(i) standards in Sections PS 1201-PS 3510;
(ii) Public Sector Guidelines; and
(iii) appendices and illustrative material of those pronouncements described in (i)-(ii) above.

SOURCES OF GAAP
.04 A public sector reporting entity should apply every primary source of GAAP that deals with the accounting and reporting in financial statements of transactions or events encountered by the public sector reporting entity. [APRIL 2005]

.05 When the primary sources of GAAP do not deal with the accounting and reporting in financial statements of transactions or events encountered by the public sector reporting entity, or additional guidance is needed to apply a primary source to specific circumstances, the selection of an appropriate accounting policy requires the exercise of professional judgment. In these circumstances, a public sector reporting entity should adopt accounting policies and disclosures that are consistent with:
(a) the primary sources of GAAP; and
(b) the application of the concepts described in FINANCIAL STATEMENT CONCEPTS, Section PS 1000. [APRIL 2005 *]

06 The primary sources of GAAP provide the financial statement accounting and reporting requirements, as well as explanations and guidance for most transactions and events encountered by a public sector reporting entity. Management is required to be knowledgeable about the primary sources of GAAP. As well, management is required to be aware of changes to the primary sources, because what constitutes GAAP at a particular time changes and adapts to reflect economic and social conditions.

.07 No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise. As a result, matters may arise that are not specifically addressed in the primary sources of GAAP. It is necessary to refer to other sources when the primary sources do not deal with the accounting and reporting in financial statements of transactions or events that a public sector reporting entity encounters, or when additional guidance is needed to apply a primary source to specific circumstances.

.08 A public sector reporting entity consults sources other than primary sources of GAAP to assist in selecting accounting policies and disclosures only when these sources comply with paragraph PS 1150.05. The public sector reporting entity evaluates sources in selecting the appropriate accounting policies and disclosures based on all of the following criteria:
(a) The specificity of the source — A source that deals with the specific circumstances is likely to be more relevant than one from which the public sector reporting entity must analogize.
(b) The authority of the issuer or author — A source issued by an accounting standard setter in its own jurisdiction is likely to be more relevant than a source issued by others in the same jurisdiction.
(c) The continued relevance of the source — The passage of time may diminish the relevance of certain sources.
(d) The development process for the source — A source developed after extensive consultation and debate is likely to be more relevant than a source developed without such discipline.

.09 The selection of appropriate accounting policies and disclosures requires the exercise of professional judgment. In exercising professional judgment, a public sector reporting entity takes into account the primary sources of GAAP, as well as the concepts described in paragraph PS 1150.05(b). The public sector reporting entity would not analogize to a primary source of GAAP if the source used states that it applies only to the particular circumstances described therein.

.10 A public sector reporting entity considers all sources of GAAP that it consults in the context of the concepts described in paragraph PS 1150.05(b), which describes the concepts underlying the development and use of accounting principles in financial statements. A public sector reporting entity adopts accounting policies that are consistent with these concepts. The Public Sector Accounting Board (the Board) considers a source to be consistent with the concepts in paragraph PS 1150.05(b) when the guidance in that source is compatible with the qualitative characteristics of financial information, the elements of financial statements, and the recognition and measurement criteria in paragraph PS 1150.05(b).

> .11 In selecting appropriate accounting policies and disclosures, interpretations of a source do not constitute evidence that the criteria in paragraph PS 1150.05 have been met if it is likely that most parties, exercising professional judgment, would reject them as not resulting in a fair presentation in accordance with GAAP.
>
> .12 When the concepts described in paragraph PS 1150.05(b) conflict with a primary source of GAAP, the requirements of the primary source of GAAP prevail. The Board is guided by the concepts described in paragraph PS 1150.05(b) in the development of future pronouncements and in its review of existing pronouncements. Therefore, the number of cases of conflicts between the concepts described in paragraph PS 1150.05(b) and primary sources of GAAP will diminish over time.

Application of PS 3250 to Joint Defined Benefit Plans

A joint defined benefit plan is a unique sort of retirement benefit plan where the sponsors have shared control over the plan. As a result, no one party can, by itself, control decisions around funding, benefits and other matters; funding contributions, risks and benefits are to be shared mutually between the sponsors. We would note that paragraph .081 clearly states that a government should account for its portion of the plan in accordance with the standards for defined benefit plans. As a result, the Province of Ontario accounts for its proportionate share in the pension plan and has historically recorded its share as 50% of the plan.

The Province of Ontario's Public Accounts have included a pension asset related to OTPP since fiscal 2001/2002. This situation has arisen because, to this point in time, the government's share of the total contributions to the plan plus the actual investment returns on the plan's assets have exceeded the government's share of the accumulated retirement benefit expense. The accounting for the accrued benefit obligation results from a complex process involving significant assumptions and actuarial calculations covering a very long time frame as is required by S 3250. S 3250.51 includes an explicit acknowledgement that the accounting position and funding position can be quite different, as follows: "Contributions reflect the funding objectives of the plan. The benefit expense reflects the accounting objectives and may differ for a number of reasons."

The assumptions used in the calculation of the accrued benefit obligation are required to be the "government's best estimate of expected long-term experience and short-term forecasts" (3250.42) and each key assumption must be based on the government's best estimate of those future events that have an effect on the accrued benefit obligation (3250.41). This approach is designed to recognize the long-term nature of the retirement promises with appropriate consideration of, but not undue influence of, experience expected in the short-term. 3250.57 requires that the future service cost calculation included in the calculation of the valuation allowance be determined on a consistent basis with that used to determine the accrued benefit obligation itself. The OPCD has determined the discount rate to be used in valuing the pension obligation related to OTPP by referencing the expected rate of return on plan assets, which is one of the acceptable references suggested on PS 3250.44. We make no comments on the actual rates that were chosen.

Commented [NP3]: It's not actually us, its' ISPPD (best to say MOF)

Application of the limit on the carrying amount of an accrued benefit asset

PS 3250.50 requires that an accrued benefit asset should be presented on a government's statement of financial position net of any valuation allowance. 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. This comparison between the adjusted benefit asset and the expected future benefit informs whether a valuation allowance is required and if so, how much of a valuation allowance should be recorded. (It should be noted that "accrued benefit asset" and "adjusted benefit asset" are defined terms used in S. 3250. As at March 31, 2016, in this particular case, these two amounts are the same, as noted in the above facts.

PS 3250.52 contemplates that there are two ways in which a government can benefit from an accrued benefit asset. A government may benefit from an accrued benefit asset either by withdrawing surplus assets or by taking a contribution holiday or receiving a refund of contributions. As such, an expected future benefit would include the ability to either withdraw plan assets from the plan or reduce future contributions.

PS3250.52 also goes on to consider that an accrued benefit asset may become impaired when there is a plan surplus that the government is not entitled to benefit from fully. The paragraphs that follow determine how a government would go about considering the extent of any impairment, which would give rise to a valuation allowance. In order to make this determination, the government is required to consider the "expected future benefit", which would effectively create a ceiling for the asset. Here the guidance diverges between benefit expected to be realized through future reductions in contributions and those to be realized through withdrawal of service.

Specifically with respect to withdrawal of surplus, PS 3250.59 is very clear that expected future benefit can only be asserted where the government has a current legally enforceable right to withdraw assets from the plan. We considered whether this guidance should be applied to cases where the expected future benefit related to the pension asset is expected to be realized through reduced contributions and concluded that the guidance does not apply in this situation. While PS 3250.59 does introduce the concept of a legally enforceable right, it does so solely in the context of a government's future withdrawal of a plan surplus, and not in the context of a government's reduction of future contributions. We believe that the standard setters deliberately and justifiably established a higher hurdle for surplus withdrawal, which involves removing assets that had previously been placed in trust for retiree benefits. If the standard setters had intended legal enforceability to be the test, they would have included that notion throughout the guidance, instead of only raising it in the context of a withdrawal of surplus. In the situation at hand, the Province is not asserting an expected future benefit based on surplus withdrawal. Instead the Province's position is that the future benefit is expected to be realized through future contribution reductions. Therefore, we do not believe that 3250.59 applies in this case.

Additionally, in forming our view on the application of PS 3250 to Joint Defined Benefit Plans, we noted that there was specific guidance (PS 3250.81) that requires the Government to account for portion of the plan in accordance with the standards for defined benefit plans. In looking at the GAAP hierarchy in PS 1150, we noted PS 3250 is considered to be a primary source of GAAP.

Commented [CV4]: Suggest "is" vs. "was"

For the reasons stated above, we are of the view for question 1, stated at the outset of this report, that legal enforceability of a government's right to access a pension plan surplus through future contribution reductions is not necessary to justify recognition of a pension asset.

With respect to question 2 stated above, we offer the following:

Since legal enforceability is not the test for a reduction of contributions, we further considered what role legal considerations should play in the measurement of the pension asset. We note that PS 3250.52 requires one to consider "uncertainties as to a government's legal right to use a plan's accounting surplus." Our interpretation of this guidance is that it presents a lower threshold than legal enforceability. Specifically, the amount of pension asset that gets recorded needs to be subject to considerations around any legal uncertainties. This consideration will involve significant professional judgment. However, it is our view that uncertainty does not need to be reduced to zero in order to recognize a pension asset.

PS 3250.53 to .58 lay out a mathematical calculation that determines the adjusted benefit asset and the expected future benefit, and tests whether a government can expect to recover its accrued benefit asset through a withdrawal of surplus or through the reduction of future contributions. The stated objective of this exercise, as set out in PS3250.055, is to limit the amount of the government's accrued benefit asset to the amount "it can realize in the future." The expected future benefit is further described as "a calculated amount representing the benefit a government expects to realize from a plan surplus", where realization includes a reduction in future contributions. A valuation allowance is recorded against the pension asset to limit the asset value, if necessary, based on this analysis.

PS 3250.55 indicates that the expected future benefit is a calculation that represents the benefit a government expects to realize from a plan surplus. This calculation is further described in PS 3250.56(a), which sets out that the government's calculation of expected future benefit would be 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. Note that in the case at hand, the calculations are done on a 50% basis since the starting point, per PS 3250.81 and as set out in the fact summary above, is that the government accounts for its portion of the plan. For this same reason, employee contributions are also excluded in this case since they would represent the teachers' portion of the plan.

PS 3250.55 indicates that the expected future benefit is a calculation that represents the benefit a government expects to realize from a plan surplus. The expected future benefit would operate as a ceiling on the pension asset value to be recorded in the accounts. For example, if the pension asset were $150, but the expected future benefit calculated as described above were $100, a valuation allowance of $50 would be recorded against the pension asset and the asset recorded in the government's financial statements would be reduced to $100.

The expected future benefit calculated per PS 3250.56(a) would operate as a ceiling on the pension asset value to be recorded in the accounts. For example, if the pension asset were $150, but the expected future benefit calculated as described above were $100, a valuation allowance of $50 would be recorded against the pension asset and the asset recorded in the government's financial statements would be reduced to $100.

Commented [CV5]: Is this paragraph better positioned before the one above – its related to .55 vs. .56

KD: I've done some different reordering

There are two parts to the calculation of expected future benefit. The first part of the calculation is the sum of the present value of the expected future accruals for service for the current number of active employees. This amount is required to be calculated using consistent assumptions as those used for the calculation of the accrued benefit obligation itself. The second part of the calculation is the present value of required employee contributions and minimum required contributions by the government itself, regardless of any surplus. The main area for judgment in the above calculation is in the determination of future minimum contributions required to be made by the government regardless of any surplus. There is no further guidance in S 3250 as to how this calculation should be performed and what restrictions or parameters should be factored into this calculation.

Determining the number of years of contributions to include should involve consideration of legal uncertainty as set out in PS 3250.52. It is not the purpose of this report to resolve the question of at what point this uncertainty would be sufficiently low regarding when contribution reductions may reasonably be expected. However, we would observe that there are a number of considerations that are relevant to consider. As part of this analysis, we reviewed Osler's legal letter of September 20, 2016. That letter makes a number of observations about the plan agreements and governing documents that we will not reiterate here. Osler's do note that legal enforceability does not exist. But as noted above we do not believe that legal enforceability is required in this case.

The decision as to the amount of future reductions in contributions to use in the asset limit calculation will rely on negotiation and agreement between both sponsors, who are required under the plan governing documents to bargain in good faith. While it is impossible to predict the outcome of future negotiations with full certainty, we believe that the challenge here is to reduce the risk to a sufficiently low level to justify the amount recognized. There are a number of factors to consider and it is possible for reasonable professionals to arrive at different conclusions, even when confronted with the same set of facts and circumstances. These considerations will be highly judgmental.

In developing calculations for the asset ceiling test, Deloitte provided a report dated August 18, 2016 entitled Asset Ceiling Calculations for the Ontario Teacher's Pension Plan that was used by management to determine that no valuation allowance was required against their pension asset as at March 31, 2016. That report was prepared to assist OPCD management in preparing their own analysis. We were not engaged to and did not express an opinion on the amount of or need for any valuation allowance, nor do we express an opinion on this analysis at this point. Reference to the August 18, 2016 report in this report should in no way be construed as an opinion on that earlier report.

With respect to these judgments, we offer the following observations which have been put forth by management:

- Plan documents and design contemplates the shared nature of the plan.
- Section 10 of the Partners agreement require that the partners meet every 3 years to discuss changes to the plan.
- As described in the facts above, there was a long history of sharing surpluses through various mechanisms during the 1990's when funding surpluses were more common. The FMP also contemplates a sharing of surpluses.
- As described to us by management, in addition to the history of surplus utilization noted in the facts and assumptions, it is worth noting that the actions taken around inflation indexation and subsequent restoration of those benefits are a recent example of the sharing philosophy governing operation of the OTPP. Starting in 2011 in response to a deficit situation, it was determined that indexation would be reduced for teachers retiring after 2009. Consistent with the 50/50 approach inherent in the plan operation, the government agreed to make payments into the plan that would effectively match the value of benefits foregone by teachers. In 2014, 2015 and 2016, surpluses were used to restore some of the lost indexation. This decision results in a decrease in the Province's share the pain payments.
- The FMP explicitly considers the possibility of contribution reductions at different funding levels, although both sponsors need to agree. The OTPP's investment performance has consistently outperformed expectations. If this situation continues the funding surplus will only continue to grow. Modelling could be performed to help estimate when the different funding zones will be reached and probability of contribution reductions may be increased.
- We also note that Canada Revenue Agency establishes limits for pension surpluses. When these limits are breached, steps need to be taken to reduce the surplus. In such a situation, contribution reductions would be one way to reduce the surplus that would need to be negotiated by the parties within their overall framework for negotiation. Again, modelling could be done to develop expectations as to when these CRA limits could be expected to be reached.
- Contributions are borne equally by the Province and the teachers. It may be reasonable to presume that teachers will also want to see contribution reductions at some point. Admittedly, increases in benefits could also use any surplus; however, it may be reasonable to expect that the

Commented [CV6]: We discussed this sentence – I think it is true that the decision as to the amount of future reductions… will rely on negotiation, but don't think that that negotiation is required before determining what amount to include in the asset limit calculation.

This is an important point.

Commented [NP7]: We discussed this term previously. It has been deleted above. Should it be edited here as well?

Commented [CV8]: I think the statement would be better included in the beginning of the report after the facts and assumptions section vs. in the middle of the analysis

Commented [CV9]: We talked about this point as well – these are not just considerations but forth by management – are you saying you don't agree that these should be considered?

interests of taxpayers and teachers will need to be weighed in the “good faith” bargaining process such that unequal weighting towards increases in benefits may be unlikely.

- In determining the range of possible outcomes, it is noted that measurement uncertainty may exist (PS 2130.03). This paragraph also notes that many items are measured using management's best estimates based on assumptions that reflect the most probable set of economic conditions and planned courses of action.

However, application and weighting of these and other considerations is a highly judgmental exercise and it is possible that there is a range of reasonable conclusions that may result in a range of reasonable estimates for the valuation allowance to be taken against the pension asset. We are unable to opine on whether a valuation allowance is needed, and if so, what a reasonable range of estimates would be.

Commented [CV10]: How does this statement tie into what you have added re: 2130?

Given the complexities and degree of judgment involved in these matters, appropriate disclosure is a matter of significance as is recognized in 3250.83 which states, in part, *“Full disclosure is particularly important for retirement obligations because the measurements depend heavily upon judgments rather than objective evidence”*. This importance is also highlighted in the context of joint benefit plans in 3250.93 which require that the unique nature and terms of any joint plans be disclosed.

The ultimate responsibility for the decision on the appropriate application of Canadian Public Sector Accounting Principles for the specific transaction described above rests with management as preparers of the financial statements, who should consult with the Auditor General of Ontario. Our judgment on the appropriate application of Canadian Public Sector Accounting Standards for the specific situation described above is based on the facts, circumstances and assumptions provided to us. Should the facts, circumstances or assumptions differ, our conclusion may change.

This report is intended solely for the information and use of Ms. Karen Hughes and management of Her Majesty the Queen in right of Ontario, as represented by the president of Treasury Board through the Office of the Provincial Controller and is not intended to be and should not be used by anyone other than the above party and the Auditor General of Ontario or for any other purpose. For further clarity, this report should not be distributed to anyone outside those named in the previous sentence, nor should it be quoted from outside this group for any purpose. Please contact Kerry Danyluk, National Director of Accounting Services, regarding any questions about the content of this report (416 775-7183 or kdanyluk@deloitte.ca).

(To be signed Deloitte LLP)

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