Submission by the
Public Service Alliance of Canada to the
Department of Finance Canada regarding

Proposed Changes to Reporting of Gains and Losses in the Government's Financial Results

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PSAC AFPC
Public Service Alliance of Canada
Alliance de la Fonction publique du Canada

Introduction

The Public Service Alliance of Canada (PSAC) is one of Canada's largest unions. It represents more than 200,000 workers in every province and territory in Canada and in locations around the world. Our members work for federal government departments and agencies, Crown Corporations, universities, casinos, community services agencies, Aboriginal communities, airports, and the security sector, among others.

Along with members of the Canadian Forces and the RCMP, PSAC members are the primary beneficiaries of both the pension plan for the Public Service of Canada (PSPP) and of the Public Service Health Care Plan (PSHCP). These plans represent the largest proportion of employee pensions and other future benefits plans that are reflected in the federal government's financial reporting.

As such, PSAC has a first-hand stake in the issue at hand and appreciates the opportunity to offer input to the Department of Finance as part of this consultation process.

PSAC supports the use of the Operating Balance concept as a supplemental element of transparency to traditional financial reporting of the government's obligations with respect to employee benefits plans.

However, PSAC submits that the recent changes to the discount rate methodology, which ties pre-2000 pension liabilities to the present-day long-term government bond rates accentuates volatility and is misleading. It acts as though the present-day market is the only relevant measure of reality when we know that pension obligations are discharged over the long-term.

That stated, PSAC believes that the unique nature of future employee benefits promised as part of its members' terms of employment warrants separate reporting.It further believes, as acknowledged in the consultation paper, that the magnitude and relative volatility of actuarial gain and losses run the risk of obscuring government spending on programs if they remain commingled with overall program expenses. Government should not rely on these gains and losses to either sponsor or cut other program spending, knowing that they are inherently transient and result directly from the method selected to evaluate these particular expenses.

The great divide

In the case of government-sponsored pension plans, no assets were actually invested prior to April 1, 2000. Rather, notional accounting entries known as *Superannuation Accounts* were used, until Bill C-78 came into force. This bill made significant changes to the Superannuation Acts and established a *Pension Fund* in each of the Superannuation Acts that replaced the *Superannuation Accounts* for post-March 31, 2000 service. Since April 1, 2000, employee and government contributions in respect of current service have been made to these *Pension Funds*. All benefits for pensionable service prior to April 1, 2000, when paid, are charged to the appropriate *Superannuation Account*. However, benefits paid for service thereafter are paid from the appropriate *Pension Fund.* Bill C-78 also required the Minister to debit from the *Superannuation Account* certain amounts in excess of specified actuarial surplus ceilings.

It is worth remembering that, on the basis of Bill C-78, the government "repurposed" over $28 billion directly from the *Superannuation Accounts* between 2001 and 2004, thereby reducing the actuarial surplus in those accounts. This was the object of a legal claim for the return of actuarial surplus that was initiated by several unions and associations – including the PSAC, which was ultimately heard by the Supreme Court of Canada (SCC), in which PSAC was joined by multiple labour associations as Appellants.

In its 2012 ruling[1], the SCC observed that:

> Beginning with the 1990-91 Public Accounts (Canada's annual financial reports), the government began to "amortize" the actuarial surpluses in the *Superannuation Accounts.* The effect of this "amortization" was twofold: it reduced the government's annual budget deficit (or increased the annual budget surplus) by reducing annual pension expenditures, and it brought the government's net debt down by reducing the net pension liabilities to an amount closer to the actuarial estimates of the government's future pension obligations.
>
> Bill C-78 established a legislated undertaking on the part of the Board (the administrator of the new *Pension Funds*) to act in the best interest of contributors, but only in respect of post-April 1, 2000 contributions.
>
> … the Board is "to manage amounts that are transferred to it ... in the best interests of the contributors and beneficiaries under those Acts". These words are not found in the Superannuation Acts in respect of the *Superannuation Accounts.*
>
> The *Superannuation Accounts* are legislated records and do not contain assets in which the appellants have a legal or equitable interest. The Plan members' interests are limited to their interest in the defined benefits to which they are entitled under the Plans.

Thus, the appeal was denied by the SCC – confirming the decisions of the lower courts, who concluded that *Superannuation Accounts* are no more than informational accounting records designed to track the operation of the Plans and to estimate the government's future pension liabilities. In the court's view, there was no borrowing from these accounts; there was no debt owing to them; there was no property in them.

From April 1, 2000 onward, the funding scheme selected for these government-sponsored plans shifted from a pure "pay-as-you-go" approach to a partially funded one – it will take decades more before *Pension Funds* effectively become the only source and *Superannuation Accounts* become a thing of the past. This carries a number of implications, some of which are far from obvious to the average reader of the government's financial statements. Notably, funded schemes are dependent on investment earnings that are affected by the evolution of interest rates and capital markets, which are also affected by inflation. There is inherently greater volatility to any scheme that reflects the state of markets at any given point in time, yet numerous OECD countries have moved away from "pay-as-you-go" schemes and toward at least partial funding for government-sponsored plans, in part to compose with foreseen cost increases related to their ageing populations.

[1] Professional Institute of the Public Service of Canada v. Canada (Attorney General), 2012 SCC 71, [2012] 3 S.C.R. 660: https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/12778/index.do

A matter of choice

Pension benefit security is simply not enforced the same way in the PSPP and other government-sponsored pension plans as it is in the private sector. In the latter case, minimum standards legislation requires that assets sufficient to cover the full present value of future benefits are set aside so they can grow through investment returns until the benefits are paid out.

While assets are now indeed set aside and invested by the Public Service Pension Investment Board (PSPIB) in respect of benefits related to service from April 1, 2000 onward, the same cannot be said for benefits earned for service before this date. This distinction is extremely important because investment returns are even more important than the contributions made to fund the benefit promise. It is also a determining factor in the different accounting treatment afforded to the pre- and post-2000 benefits.

Expected return on plan assets versus cost of borrowing

From an accounting perspective, because *Superannuation Accounts* are unfunded, the value of pre-2000 benefits is established based on the government's cost of borrowing, which effectively ties it directly to "risk free" present-day long-term government bond rates.

This contrasts sharply with *Pension Funds,* whose assets are set aside and invested by the PSPIB, with the expectation of future returns that contribute very strongly to funding the benefits that they support. The mandate of the PSPIB is to "invest its assets with a view to achieving a maximum rate of return without undue risk of loss". Its performance reflects this mandate with a 10-year net annualized return of 10.7% through the end of fiscal year 2019 on a diversified portfolio of investments worth $168 billion[2].

Even though the funding practice changed over 20 years ago, the benefits to be paid in respect of services rendered prior to that change remain very significant today. In the report on the PSPP's latest actuarial valuation, as at March 31, 2017, liabilities for such service were $97B, while those for services rendered from April 1, 2000 onward were $87B[3]. Thus, it will take decades more before *Superannuation Accounts* become a thing of the past and *Pension Funds* support the full pension promise made to all its members with actual invested assets.

To most readers of the government's financial statements, the distinction between how these two periods are valued is easily lost even though its consequences are far-reaching. Far worse though, tying a still-significant proportion of the overall benefit obligation to market yields of debt instruments makes them perpetually volatile and subject to potentially large swings even over the short-term. It acts as though the present-day market is the only relevant measure of reality when we know that its changes can be both radical and relatively short-lived – at least compared to the very long-term nature of pension obligations.

[2] Public Service Pension Investment Board, 2019 Annual Report [2019], p.4: www.investpsp.com/media/filer_public/documents/PSP-2019-annual-report-en.pdf

[3] OSFI - Report on the Actuarial Valuation of the PSPP as at March 31, 2017, [2018] pp.12-13: www.osfi-bsif.gc.ca/Eng/Docs/PSSA2017.pdf

Throughout the 1980's, federal long-term bond rates averaged over 11.8% - even exceeding 18% at one point, though over the last few years these same bonds yields have been around 2% or less. The very same benefit obligations, if discounted according to such dramatically different market rates, would range from very small amounts in the 1980's, to very large ones today. There is therefore a very real risk for misinterpretation of the financial disclosures at any given point in time.

In the report on the PSPP's latest actuarial valuation, as at March 31, 2017, the actuary assumed that real rates of return for the *Pension Fund* would increase between 2018 and 2028 from 3.1% to 4.0%[4]. De facto, this means that the present-day market returns at the valuation date were below their long-term expectations for investment returns on invested assets. A flat real discount rate of 3.7% was therefore selected for the purpose of calculating the liability as at March 31, 2017 for service since April 1, 2000.

Meanwhile, the projected yields on the *Superannuation Accounts* were assumed to be 0.8% in plan year 2018 and expected to increase gradually to an ultimate level of 2.7% in plan year 2028.

As is typical for actuarial valuation reports, the PSPP report provided additional disclosures known as "sensitivity testing". These disclosures allow the reader to understand how much the results presented would vary if key assumptions, like the discount rate, were to be different from those selected (such as 1% higher or 1% lower). The addition of such information is very helpful to prepare readers for the inevitable changes that should be expected to occur in subsequent years, although the nature of the benefits themselves may not change.

This is best illustrated in the following table, drawn from the PSPP's latest actuarial valuation report as at March 31, 2017[5]:

TABLE 18 SENSITIVITY OF VALUATION RESULTS TO VARIATIONS IN KEY ECONOMIC ASSUMPTIONS

			Actuarial Liability ($ millions)			
	Current Service Cost (%)		Service prior to April 2000		Service since April 2000	
Assumptions(s) Varied	2019	Effect		Effect		Effect
None (i.e. current basis)	20.16	None	97, 137	None	87, 313	None
Investment yield						
- if 1% higher	16.05	(4.11)	86, 598	(10,539)	73, 483	(13, 830)
- if 1% lower	25.81	5.65	109,998	12, 861	105, 375	18, 062

Note how the liabilities for pre- and post-2000 service are not affected to the same degree by a change in expected investment yields – in fact, the pre-2000 service is not impacted at all. Adding similar disclosures to the government's financial reporting – together with associated comments that clarify the sensitivity of the obligations presented for employee benefits plans, would enhance their understanding.

[4] OSFI - Report on the Actuarial Valuation of the PSPP as at March 31, 2017, [2018] p.61: www.osfi-bsif.gc.ca/Eng/Docs/PSSA2017.pdf

[5] (Idem), p.21

Changes to accounting policies that increased volatility

BACKGROUND

Beyond the fundamental and lasting differences that exist between the funded and unfunded pre- and post-2000 benefit obligations, the change made to accounting policy in 2018 impacted how pre-2000 pension benefits are valued. Making this change added $19.6B to the public sector's unfunded pension liabilities[6]. The policy change also made these particular obligations far more volatile by tying their valuation discount rate to the actual yield curve in effect at the valuation date, i.e. at a specific point-in-time. Under the previous policy, a 20-year moving average of long-term bond rates was used, which naturally produced a far more stable discount rate, albeit less reflective of the most recent market experience.

The reasons invoked for making this change referred to the Auditor General's comments on the government's consolidated financial statements for previous years, as well as on trends in Canadian and international accounting standards[7].

Thus, the suggested changes outlined in this Consultation Paper come during a period of already significant change to accounting policy. We therefore believe it worthwhile to take a cautious approach which recognizes the following:

1. Acknowledging the reasons for now requiring this new model of "operating budget";

2. Potential improvements to the suggested model which focus on the location of, and the narrative disclosures around, the operating budget figure, and;

3. Flexibility to adapt the suggested model going forward.

We elaborate as follows.

1) Acknowledging discount rate *choice* among the reasons for now requiring this new model of operating budget

We understand the accounting issues in this scenario as a progression of inter-related steps. These are situated within a broader, global context in which both private and public sector entities have been facing similar challenges. They include:

1. The move to accrual accounting (common across governments globally during the past decades). As a result, the need to value the pension obligation and the selection of a discount rate for its valuation.[8]

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[6] Office of the Auditor General of Canada, *Commentary on the 2017-2018 Financial Audits:* http://www.oag-bvg.gc.ca/internet/English/parl_oag_201810_00_e_43161.html

[7] Treasury Board Secretariat [2018], *Review of Methodologies to Determine Discount Rates,* Sections 2.1 and 4: https://www.canada.ca/en/treasury-board-secretariat/corporate/reports/review-methodologies-determine-discount-rates.html

[8] Though the actuarial gain/loss is comprised of various factors, the discount rate selection has been a source of much of the debate around the volatility for accounting disclosures – and is a focus of the Consultation Paper – we therefore feel it is appropriate to focus on it in this section.

2. The adoption of discount rates for accounting measurement that reflect fair value/"financial economics" views – resulting in the increased tendency across jurisdictions to select discount rates that mirror a shorter-term, so-called "risk free" rate[9]. Research is unsettled on all of the impacts of a move to fair value, (whether the move to fair value precipitated the 2008 financial crisis, for instance). But what *can* be said with certainty is that the fair value approach has introduced volatility to the valuation, via the balance sheet, of those entities who employ it.[10]

3. From that resulting volatility, various other jurisdictions have contemplated disclosures to deal with, or de-emphasize, its impacts.

These statements are uncontested information that are part of the historical background to these new changes. We believe that this historical background is important information that should be disclosed included in notes tied to any new reporting format. **We note that the selection of discount rates – whether by the standard setting body in question or the entity in question – is the result of a choice among different ways to measure the obligation, and not an inevitable conclusion.** It would be helpful for users of these financial numbers to understand this, and we will later recommend some related narrative disclosures.

2) Creation and presentation of operating budget

We agree with the principle of transparency and support the idea to disclose relevant information concerning the pension obligations. However, we believe that careful selection of a format for disclosure, accompanied by narrative information, will be important. This is particularly the case when defined benefit pension plans are a target of certain actors and the subject of considerable scrutiny. Defined benefit pension plans are a fundamental pillar of the Canadian retirement system, and collectively contribute trillions in economic capital to the global financial markets, including the Canadian markets. We advocate for defined benefit coverage across both public and private sector and are concerned about the narrative that characterizes defined benefit plans as a luxury.

As noted in the Consultation Paper, some approaches have incorporated gains and losses from pension and benefit plans into Comprehensive Income (e.g. IFRS). The belief in such an approach is that, though these items flow through to equity, they do not impact the 'bottom line' in the way that they would had they been included in the determination of profit.

We understand that the approach that is proposed herein is taken in the same spirit: to deal with the resulting volatility and the inclusion of such measurements into the bottom-line budgetary numbers. We agree with the approach in principal. We believe that, once it was decided to utilise discount rate methodology which introduced new volatility into reported numbers, the next logical step would be to determine a way to better communicate those numbers. We continue to highlight, however, that the choice of discount rates is a precipitating factor in the desire to now split these numbers apart.

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9 Himick, D. and Brivot, M. (2018). Carriers of ideas in accounting standard-setting and financialization: The role of epistemic communities. Accounting, Organizations and Society, 66: 29-44.

10 Magnan, M. L. (2009). Fair value accounting and the financial crisis: messenger or contributor? Accounting perspectives, 8(3), 189-213. Many academic and professional studies have been conducted on the volatility inherent in fair value methodology. The Consultation Paper also states: "This volatility has increased in recent years, with the introduction of a new discount rate methodology in the 2018 Public Accounts of Canada for valuing unfunded pension and other future benefit obligations. Prior to the change in methodology, unfunded pension obligations were discounted using a 20-year moving average of Government of Canada long-term bond rates, which resulted in a relatively stable discount rate. Under the new methodology, unfunded benefit obligations are discounted based on the spot rates of Government of Canada bonds at fiscal year-end (March 31), *which can fluctuate significantly from one year to the next.*" (emphasis added).

The first item to address should be the placement of the operating balance and "traditional" budgetary balance.

The Consultation Paper states:

The practice of separately reporting revaluation gains and losses is also used in the Canadian private sector, under International Financial Reporting Standards, whereby all actuarial gains and losses flow directly to other comprehensive income, outside of net income.[11]

This is true, however the approach taken by IFRS and the approach suggested herein are different in two fundamental ways. First, as noted in the Consultation Paper, the financial impact under IFRS is felt *outside* of net income – while the financial impact suggested herein would both visually and actually impact the number that the Government is proposing as its primary budget number: the traditional budgetary balance. Second, in the private sector, the "bottom line" number used by external users to evaluate performance is still net income – and *not* comprehensive income.

Indeed, research has found that users pay only secondary notice to comprehensive income.[12] Further, as a practical matter, common financial ratios and other metrics of performance utilize net income.

Thus, we would suggest confronting these differences head on and splitting the numbers up – similar to entities reporting under IFRS. Rather than putting the operating budget and the budgetary income together in the same statement, these could be split apart so that focus is where the Government wants the focus to be, i.e., the operating budget.

The Government would continue to present the traditional budgetary balance, or annual deficit/ surplus, in its budget and financial reporting as the most comprehensive measure of financial performance. However, the operating balance could act as a useful supplementary measure…

These statements are weighted heavily on the premise that whoever uses the information will understand which measure to use. While it is true that the Government can easily track and use whichever measure it wants to, the same cannot be said for external users, who are not privy to the same understanding of the two numbers.

The quoted statements misunderstand the fact that users would not have the relevant background to interpret the two numbers and risk both confusion and selective interpretation. To forestall this, the Government should be clear and explicit about which number should be interpreted by users of this information as the primary number. This can be done in the form of a narrative disclosure.

By isolating the impact of re-measurements of previously-recorded pension and other employee future benefit obligations, the operating balance could provide users of the Government's financial plans and reports with a clearer view of its planned and actual operating activities in an accounting period, enhancing transparency and accountability.

[11] https://www.canada.ca/en/department-finance/programs/consultations/2020/proposed-changes-reporting-gains-loses/consultation-paper.html.

[12] Durocher, S., & Fortin, A. (2015). Comprehensive income information: a user's perspective. *International Journal of Behavioural Accounting and Finance*, 5(1), 27-56.

We agree with this, however we caution that as currently presented, the operating balance appears visually to be embedded as an item of only secondary importance, with the most important item visually (the "bottom line"), being the Budgetary Balance. We would strongly suggest examining alternative ways to represent the item in order that the Operating Balance is highlighted as a measure for decision-making and analysis. This is similar to our suggestions provided above, to more concretely split these numbers apart.

The "location" of reported numbers matters very much.[13] It could be relevant to conduct an empirical investigation (experimental, survey) to determine which different reporting formats are used or interpreted in different ways by various user groups. This would eliminate some of the guesswork around whether simply splitting off a component into its own line item, or creating a new line item, will have the desired effect.

2.1 Narrative disclosures

Other issues in the new reported figures should be dealt with by providing narrative disclosures.

a) **A disclosure should address the nature of the volatility inherent in the newly split-out actuarial gains/losses number itself.**

Volatility is not going to go away; it will be a feature of this reporting as long as the discount rates selected are short term in nature. This volatility is a characteristic of the move to fair value measurement in accounting, and this is recognized in accounting policy, research, and practice. The quotation below[14] provides some context:

Not just in North America but throughout Europe and even as far as the Middle East there has been a critical ongoing discussion about the shortfalls of FVA. Some have suggested that the method itself actually contributed to the spiraling recession in these economies.

Apply it during a recession and it will drive equity values down and raise plan debt. Use the same method in a period of rapid economic expansion and it will drive surpluses to unrealistically high levels. No wonder Canada's Chief Actuary has chosen the more traditional HCA in analyzing plan performance and position. It is also reassuring that our Auditor General, charged with protecting the public purse, has never found the public to be subject to any unreasonable or underappreciated risk in its public service pension plans.

Once fair value measurement is incorporated into reporting, the *interpretation* of these measurements becomes highly relevant. Negative and positive volatility are perceived differently by users of financial information. Research has continually demonstrated that users of financial information perceive negative information as proportionately more "bad" than they perceive positive information as "good" and this extends to actuarial gains and losses.[15] We should be prepared for just this reaction by users of government financial information (internal users as well as external users including financial market participants, ratings agencies, other governments, media, members of the pension plans, taxpayers, and citizens).

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13 Ibid., note 12.

14 Canadian Association of Professional Employees (2010). *A Balanced Perspective on Fair-Value Pension Accounting*, p.4

15 Durocher, S., & Fortin, A. (2015). Comprehensive income information: a user's perspective. *International Journal of Behavioural Accounting and Finance*, note 12. The study parallels many of the points being made herein since it deals with the presentation of Comprehensive Income and the assessment given to the actuarial gains/losses.

This leads to the need for narrative disclosures that will provide information which may counter the tendency to over-weight negative volatility. **Non-financial narrative disclosures are a key part of how accounting communicates its results, and we believe they would be valuable in this case.**

b) A disclosure should relate to the choices behind the numbers themselves, to provide information on the various decisions made (aside from discount rate selection) that impact the reported numbers.

Any disclosures related to the impact of actuarial gains/losses should incorporate the fact that it was a matter of choice on the part of the government to begin setting aside and investing assets to backstop its benefit obligations from April 1, 2000 onward. It is important to remember that government also chose to continue not to do so for pre-2000 benefits, while repurposing $28B that would have otherwise resulted in a far more positive financial position for these plans today. In other words, the complete picture related to the position of the pension plans as they impact government finance, is important information for users.

c) A disclosure should present sensitivity testing.

Sensitivity testing is part of private sector disclosures under IAS19 (introduced in 2011) related to the pension obligation, and demonstrates the impact on the variation in discount rate. These requirements entail disclosures about the sensitivity of the defined benefit obligation to actuarial assumptions. We believe that a similar analysis should be disclosed alongside the reported numbers.

The sensitivity analysis should also be linked to the Budgetary Balance. It could demonstrate how the various measurements under different scenarios would produce a different level of Budgetary Balance. This would demonstrate to the users of this information the transient and volatile nature of the item itself: *it is not the same as program spending* and this fact should be clearly communicated as such.

3) Flexibility

We should allow for future changes, as accounting standards are always in a state of flux. There are few "true" numbers in accounting, rather there are numbers that are the results of various choices among a range of methodologies. This is partly why the standard setting process invites comments from those impacted: to assist standard setters in its various choices among possibilities.

Due to the controversial nature of fair value, the ongoing debate concerning how best to disclose related items is likely to continue. Accounting standards will produce new and different ways to counteract some of the problematic effects – many of which we probably are not yet aware of. One need only look to the rush to fair value that was tempered post-2008 to understand that what is viewed as best practice in one era may not be viewed this way in others. Thus, flexibility should be incorporated into messaging in order to not give users a false sense that these matters are settled.

As part of this flexibility, we note that the Government plans to analyse the components of operating balance more precisely. The Consultation Paper states that:

The Government will explore further whether all or a subset of losses and gains should be reported outside of the operating balance. For example, the operating balance could exclude only those losses and gains due to changes in discount rates. Alternatively, the operating balance could include losses and gains arising from actual experience different from that previously assumed, and exclude losses and gains due to changes in assumptions about the future.

We agree with further exploring which components might make up the operating balance. We would strongly encourage opening this up for comments when it is being considered. In addition, we believe that splitting apart various components – some included and some excluded – has the potential for further confusion. The Consultation Paper states:

Further, a new Canadian Public Sector Accounting Standard on financial statement presentation which is set to come into effect in fiscal year 2021–22 will allow for certain re-measurement gains and losses to be reported outside of the annual deficit/surplus.

Again, this supports the idea that a message of flexibility should accompany this change. This area is in a state of flux. Fair value measurement has occupied the agenda of the accounting standard bodies and there is yet to be a consensus on the best approaches for all scenarios.

Respectfully submitted on behalf of the Public Service Alliance of Canada

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