PUBLIC SECTOR ACCOUNTING BOARD
PSAB CCSP
CONSEIL SUR LA COMPTABILITÉ DANS LE SECTEUR PUBLIC

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Re: PSAB Staff Comments on Consultation Paper "Recognition and Measurement of Social Benefits"

Thank you for the opportunity to comment. We appreciate that social benefits is one of the most important and difficult topics facing public sector accounting today.

Recently, the Ontario government announced a new public pension plan called the Ontario Retirement Pension Plan.[1] The plan will provide a defined benefit to workers who are not already members of work pension plans. It will be funded by employer and employee contributions and supplement retirement income.

This example illustrates how prevalent social benefits are in Canada. While every jurisdiction has its own unique legislation and policy design, we find two questions are inherently tied to such a social benefit:

1. What is the cost of this promise?
2. Is the plan sustainable?

What makes social benefits difficult to account for is that there is rarely consensus as to when a present obligation arises. Our goal as standards setters is to provide decision-useful information and hold governments accountable. To achieve this, accountants must record a provision for the long term obligation the moment contributions enter the fund. Costs cannot be deferred until payments are due.

We believe that in taking contributions, the government has made a firm commitment to the public. It may not know precisely who will receive the cheques and for how much, but in aggregate, it has lost discretion to avoid these costs. If these costs are not recorded until a later date, such as when claims are being made, then we have failed at meeting our goal.

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[1] https://www.ontario.ca/document/ontario-retirement-pension-plan-made-ontario-solution

General purpose financial statements may not always be able to report on the sustainability of social benefits. But for some social benefit schemes (as described above), accounting standards have an opportunity to address sustainability directly on the books. Actuarial assumptions can play a critical role in the measurement of insurance-type liabilities. Indeed, such methods are sufficient for shareholders of insurance companies to know whether reserves are sufficient to meet long term obligations.

Overall, PSAB staff is in support of the proposals in the Consultation Paper. The options are well presented and clear. Our comments to Specific Matters are in the Appendix to this letter. This document represents the views of PSAB staff and not those of the Public Sector Accounting Board (PSAB).

Thank you again for the opportunity to provide you with input on this Consultation Paper. We hope that you find our comments helpful.

Sincerely,

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APPENDIX

Specific Matter for Comment 1 (following paragraph 2.50)

In your view:

(a) Is the scope of this CP (i.e., excluding other transfers in kind, collective goods and services, and transactions covered in other IPSASs) appropriate?

Yes the scope of the CP is appropriate. Figure 2 articulates the scope well.

(b) Do the definitions in Preliminary View 1 provide an appropriate basis for an IPSAS on social benefits?

The definitions are clear and precise.

Chapter 3 – Identification of Approaches

Specific Matter for Comment 2 (following paragraph 3.4)

(a) Based on your review of Chapters 4 to 6, which approach or approaches do you support?

(i) The obligating event approach;

(ii) The social contract approach; and

(iii) The insurance approach.

Please provide reasons for your views, including the conceptual merits and weaknesses of each option; the extent to which each option addresses the objectives of financial reporting; and how the different options might provide useful information about the different types of social benefit.

The obligating event approach (i) describes the recognition issues sufficiently and encompasses the most critical question with respect to social benefits: at what point should we accrue the obligation? We believe that there is a strong argument to record social benefits no later than the point where "(c) eligibility criteria to receive the next benefit have been satisfied," and perhaps earlier, such as "(b) where threshold criteria have been satisfied." More detailed comments are provided below. We support this overall approach and would welcome its inclusion in an Exposure Draft.

Along with the obligating event approach, we also support the insurance approach. The framework for dealing with certain types of social benefits using the insurance approach is clear. It seems appropriate to recognize and measure insurance-type obligations using provisions.

The social contract approach, while a useful analogy, appears to support no measurement until such time that the contract is deemed onerous. In concept, this makes sense and could provide an elegant solution to a difficult problem. However, we worry that in practice it may be too easy for preparers to defer and deny the recognition of an onerous social contract until it is too late for the information to be decision-useful.

(b) Are you aware of any additional approaches to accounting for social benefits that the IPSASB should consider in developing an IPSAS? If yes, please describe such approach(es) and explain the strengths and weaknesses of each.

Some of the approaches discussed in "*Accounting for Social Security and Its Reform*" (Howell E Jackson, Harvard) may be of use in defining options for the insurance approach.[2]

Specific Matter for Comment 3 (following paragraph 3.4)

Having reviewed the three options in Chapters 4 to 6, are you aware of any social benefits transactions that have not been discussed in the CP, and which could not be addressed by one or more of the options set out in the CP? If so, please provide details of the social benefit transactions you have identified and explain why the options set out in the CP do not adequately cover these transactions.

We are not aware of additional transactions.

Preliminary View 2 (following paragraph 3.4)

The IPSASB considers that a combination of option 1 (obligating event approach) and (for some or all contributory schemes) option 3 (insurance approach) may be required to reflect the different economic circumstances arising in respect of social benefits. The IPSASB does not consider that option 2 (social contract approach) is consistent with the Conceptual Framework. For this reason, the IPSASB has taken the preliminary view that the social contract approach is unlikely to meet the objectives of financial reporting.

We agree.

Chapter 4 – Option 1: Obligating Event Approach

Specific Matter for Comment 4 (following paragraph 4.69)

In your view, at what point should a future IPSAS specify that an obligating event arises under the obligating event approach? Is this when:

- **(a) Key participatory events have occurred ;**
- **(b) Threshold eligibility criteria have been satisfied;**
- **(c) The eligibility criteria to receive the next benefit have been satisfied;**
- **(d) A claim has been approved;**
- **(e) A claim is enforceable; or**
- **(f) At some other point.**

In coming to this conclusion, please explain what you consider to be the relative strengths and weaknesses of each view discussed in this chapter. If, in your view, a future IPSAS should consider that an obligating event can arise at different points depending on the nature of the social benefit or the legal framework under which the benefit arises, please provide details. Please explain the reasons for your views.

PSAB currently has a standard on government transfers (PS 3410) that, broadly speaking, falls somewhere between (b) and (c) above. As it is written, the standard requires judgment as to whether future eligibility are firm criteria that need to be met for an expense/liability recognition, or whether they are merely formalities required as part of the process for claiming entitlements. It may not be

[2] http://papers.ssrn.com/sol3/papers.cfm?abstract_id=458921

possible to eliminate this element of judgment from preparers and auditors as the nature of social benefits across jurisdictions can be quite unique.

We believe that there is a strong conceptual argument to record social benefits no later than the point where (c) eligibility criteria to receive the next benefit have been satisfied. Recording obligations any later than this point (claim is approved or claim is legally enforceable) is simply too late for this information to be relevant to users. While recording obligations where eligibility criteria to receive the next benefit (c) provides a starting point, it may still fall short of providing decision-useful information or holding governments to account.

In our experience, governments do not record social benefits unless eligibility criteria to receive the next benefit have been satisfied. It is argued that there is too much uncertainty to estimate anything beyond the current year's eligible accrued benefits. However, if social benefit liabilities do not include amounts because their timing and measurement is uncertain, we may not be producing useful financial statements. We must recognize that when we define liabilities for governments, Agency Theory does not apply to government financial statements.[3] Bonuses are not paid out to government employees based on the calculation of annual surplus/deficit. Banks do not make collateral calls based on a government violating its debt-to-equity loan covenant. In other words, private contracts are not settled based on a government's GAAP-based financial results. This is not how general purpose financial statements are used. Considering this, what decisions can be made about the costs or sustainability of social benefits if our goal is to simply accrue that portion of the obligation that is payable in the period?

IPSAS 19 has defined provisions, creating room for the measurement of obligations earlier than point (c) because provisions anticipate uncertain timing and amounts with long term obligations. Provisions acknowledge that when the public needs to know what the costs of a new pension plan might be, they are not inquiring about the current year's accrued obligation. Useful information would be the estimated cost of fulfilling the long-term obligation. The users are interested in knowing the long term obligation relating to the social benefits program, not the short term amount payable to current beneficiaries. This treatment holds governments to account as costs are not deferred into the future.

Specific Matter for Comment 5 (following paragraph 4.76)

In your view, does an obligating event occur earlier for contributory benefits than non-contributory benefits under the obligating event approach? Please explain the reasons for your views.

As stated in 4.73, "the existence of an obligation is not affected by the funding of that obligation." This is true. However, funding already set aside for an obligation is concrete evidence that an obligation exists. Funding for a contributory scheme hinders a government's ability to deny that a long term obligation exists. Where general taxation is used to fund a social benefit (i.e., social assistance), evidence that a government has lost its discretion to avoid payment is not as compelling. Thus, it is possible for a contributory scheme to recognize an obligation at an earlier point than a non-

[3] Although Agency Theory may apply to public sector entities such as Not-for-profits, we have not considered such entities in this analysis as such entities are unlikely to provide social benefits as defined in the Consultation Paper.

contributory scheme. This is not a conceptual difference. It is a distinction based on the evidence available to make judgments about a government's obligations to society.

Specific Matter for Comment 6 (following paragraph 4.80)

In your view, should a social benefit provided through an exchange transaction be accounted for:

(a) In accordance with a future IPSAS on social benefits; or
(b) In accordance with other IPSASs?

Please provide any examples you may have of social benefits arising from exchange transactions. Please explain the reasons for your views.

No comment at this time. We are not aware of any additional examples.

Preliminary View 3 (following paragraph 4.91)

Under the obligating event approach, liabilities in respect of social benefits should be measured using the cost of fulfillment. The cost of fulfillment should reflect the estimated value of the required benefits.

Agree.

Specific Matter for Comment 7 (following paragraph 4.91)

In your view, under the obligating event approach, when should scheme assets be included in the presentation of a social benefit scheme:

(a) In all cases;
(b) For contributory schemes;
(c) Never; or
(d) Another approach (please specify)?

Please explain the reasons for your views.

We agree with approach (a), provided there are specific contributions or restricted assets set aside for the provision in question. This approach would inform users about potential funding gaps. Second, this approach faithfully represents the value of contributory schemes. It is not in the public interest to overstate long term obligations (reporting only the gross liability and ignoring plan assets), just as it is not in the public interest to avoid recording long term obligations to begin with.

Chapter 5 – Option 2: Social Contract Approach

Specific Matter for Comment 8 (following paragraph 5.38)

In your view, under the social contract approach, should a public sector entity:

(a) Recognize an obligation in respect of social benefits at the point at which:
  i. A claim becomes enforceable; or
  ii. A claim is approved?
(b) Measure this liability at the cost of fulfillment?

Please explain the reasons for your views.

The Social Contract Approach (and executory contracts) provides a useful analogy for understanding social benefit obligations. However, recognizing only legally enforceable liabilities (or approved claims) appears to fall short of meeting financial reporting objectives.

Chapter 6 – Option 3: Insurance Approach

Specific Matter for Comment 9 (following paragraph 6.24)

Do you agree with the IPSASB's conclusions about the applicability of the insurance approach? Please explain the reasons for your views.

Agree. Where social benefit schemes resemble insurance in substance, we agree that the recognition and measurement of such schemes should follow the Insurance Approach.

Measurement – a word of caution

As stated in 6.8, insurance contracts are measured using a current estimate of future cash flows associated with the contract. When accounting for insurance contracts in the private sector, it is common practice to estimate the present value of all future cash flows related to an insurance contract obligation, which includes payment of claims/benefits along with future premiums to be collected.[4]

The observation in 6.19 is key to this approach. Financial accounting lacks symmetry when it comes to recognizing assets versus recognizing liabilities. By design, recognizing assets is harder than recognizing liabilities. In measuring a social insurance liability, the more future cash flow information we incorporate into the estimate, the more faithfully we represent that obligation. But in doing so, have we indirectly allowed a government to recognize its sovereign right to tax as an asset on the financial statements?

We at PSAB are divided on this issue. On the one hand, if a government legislates mandatory contributions that are dedicated to relieving specific social insurance obligations, should this not be considered when measuring the expected cash flows of the obligation? Do we not run the risk of overstating liabilities and misstating a government's financial position by ignoring future contributions? Perhaps more importantly, by excluding future contributions in the measurement of the liability, have we proposed a standard that might never be adopted?

On the other hand, if we permit the recognition of future contributions as an offset to measuring the social benefit obligation, have we opened a door for governments to recognize their sovereign right to tax through such obligations? What criteria or limits would stop a government from recognizing such assets as a reduction of liabilities until it no longer has any liabilities?

Can standard setters develop criteria to allow recognition of future contributions in the measurement of a liability without this precedent being applied to all future tax revenue? In the quest to faithfully represent a social benefit obligation on the balance sheet, the question of how we set parameters with respect to items that can offset the obligation is of critical importance.

[4] In Canada insurance companies use CALM (Canadian Asset Liability Model) where the measurement of an insurance contract takes into consideration scheduled premiums (cash inflows) to be paid by the customer in determining the present value of expected cash flows for the liability.

Specific Matter for Comment 10 (following paragraph 6.35)

Under the insurance approach, do you agree that where a social security benefit is designed to be fully funded from contributions:

(a) Any expected surplus should be recognized over the coverage period of the benefit; and

(b) Any expected deficit should be recognized as an expense on initial recognition?

Please explain the reasons for your views.

We understand and agree with the need for applying prudence. If it is a loss, recognize it immediately. If it is a gain, recognize it over the coverage period. However, such a proposal would appear to contradict the IPSASB conceptual framework.

Prudence is not explicitly defined in the conceptual framework. It is incorporated in the notion of neutrality, which is a component of faithful representation. In BC3.17 of the conceptual framework, the IPSASB describes prudence as the "need to exercise caution in dealing with uncertainty." This leaves us with the following conundrum – how can we claim to faithfully represent a transaction when the result of that transaction (gain or loss) is what determines its accounting treatment?

Overall, proposed approaches should be internally consistent with existing IPSASs (e.g., Employee Benefits) where their substance is comparable.

Specific Matter for Comment 11 (following paragraph 6.37)

In your view, under the insurance approach, what is the appropriate accounting treatment for the expected deficit of a social security benefit that is not designed to be fully funded from contributions:

(a) Recognize an expense on initial recognition;

(b) Recognize the deficit as an expense over the coverage period of the benefit;

(c) Offset the planned subsidy and the liability only where this is to be received as a transfer from another public sector entity;

(d) Offset the planned subsidy and the liability irrespective of whether this is to be received as a transfer from another public sector entity or as an earmarked portion of general taxation; or

(e) Another approach?

Please explain the reasons for your views.

We believe (a) and (c) are viable options. Option (b) represents deferral and amortization of a loss, which may not represent an entity's financial position accurately. As discussed above (comment 9), we worry that option (d) may represent the indirect recognition of items that would not otherwise meet the asset test.

In PSAS, governments may use note disclosure to report on funds. This supplemental disclosure provides governments with an opportunity to show the public how earmarked funds or reserved funds are being used to complete public sector projects and programs. This is a reporting option, not a requirement. We have found this type of reporting to be most common at the municipal level in Canada. While we have conceptual issues with option (d), we do believe this type of transparency and accountability has a role to play in the financial statements. Further elaboration of how such an approach would work within the financial statements would be helpful in understanding this option if it is included in future documents for comment.

Specific Matter for Comment 12 (following paragraph 6.43)

In your view, under the insurance approach, should an entity use the cost of fulfillment measurement basis or the assumption price measurement basis for measuring liabilities? Please explain the reasons for your views.

We believe the cost of fulfillment is the most appropriate measurement base for all approaches identified in the CP.

Specific Matter for Comment 13 (following paragraph 6.63)

Do you agree that, in those cases where the link between contributions and benefits is not straightforward, the criteria for determining whether the insurance approach is appropriate are:

- **The substance of the scheme is that of a social insurance scheme; and**
- **There is a clear link between the benefits paid by a social security scheme and the revenue that finances the scheme.**

If you disagree, please specify the criteria that you consider should be used. Please explain the reasons for your views.

Agree.

Framing the Insurance Approach:

In describing the Insurance Approach as a third option, it may appear to some readers that the IPSASB is proposing to restrict the recognition of social benefits to only those obligations that resemble insurance contracts. While we do not believe that this is the IPSASB's intention in setting out the Insurance Approach as a standalone option, it may be interpreted that way.

We view the insurance approach as a subset of the obligating event approach. There is broad spectrum of social benefit programs; some are like insurance. The IPSASB may conclude that the obligating event approach is appropriate for all social benefit programs. For a subset of those, there exists a specific measurement approach for the obligations that resemble insurance programs. An entire industry has developed measurement techniques for liabilities related to insurance programs and those techniques can be extrapolated to insurance-type social benefit programs in the public sector.

As stated in 6.10, this measurement approach lines up with some variants of Option 1 (threshold eligibility criteria sub-option). The Insurance Approach is an approach toward measurement of liabilities that resemble insurance contracts. The issue with respect to recognition criteria is well described and can best be dealt with as obligating events (approach 1). It is important to use such techniques where they are most applicable in order to recognize and measure liabilities for social benefits.

However, strategically, if the Obligating Event approach is not well-received, the Insurance Approach may be a theoretically supportable stand-alone approach to ensuring that some social benefit obligations are recognized as liabilities. Under this scenario, the vast majority of social benefit programs would be considered to fall under the Social Contract approach and the recognition of obligations for such programs may be limited. In contrast, social benefit programs that are comparable to insurance programs could arguably be treated differently as there are standards all over the world regarding the accounting for insurance programs; it may be hard to argue that public sector social insurance programs are substantively different.

Specific Matter for Comment 14 (following paragraph 6.72)

Do you support the proposal that, under the insurance approach, the discount rate used to reflect the time value of money should be determined in the same way as for IPSAS 25? Please explain the reasons for your views.

Agree. Internal consistency with other IPSAS is important.

Specific Matter for Comment 15 (following paragraph 6.76)

Under the insurance approach, do you support the proposals for subsequent measurement set out in paragraphs 6.73–6.76? Please explain your views.

No comment at this time.