May 26, 2020

REPORTING OF GAINS AND LOSSES IN THE GOVERNMENT'S FINANCIAL RESULTS

OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

The Parliamentary Budget Officer (PBO) supports Parliament by providing economic and financial analysis for the purposes of raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

This report responds to the Government’s public consultation, *Proposed Changes to Reporting of Gains and Losses in the Government’s Financial Results*. The report provides the PBO’s comments on changing the way that actuarial gains and losses are reported in the Government's financial results.

Contributors:
Jason Jacques, Chief Financial Officer and Director General
Chris Matier, Director General
Trevor Shaw, Director

Nancy Beauchamp, Carol Faucher, Jocelyne Scrim and Rémy Vanherweghem assisted with the preparation of the report for publication.

For further information, please contact pbo-dpb@parl.gc.ca

Yves Giroux
Parliamentary Budget Officer

RP-2021-006-S_e

Table of Contents

1. Context

Consistent with the Parliamentary Budget Officer's (PBO's) mandate to "promote(ing) greater budget transparency and accountability", our office has studied the proposed changes to the Government's reporting of financial results with interest. The following observations are informed by our experience supporting parliamentary clients in their financial deliberations, as well as technical matters concerning our ongoing analysis mandated in the *Parliament of Canada Act*.[1]

Our comments are also situated in the broader conceptual framework that underpins the preparation and presentation of public sector financial statements. Specifically, ensuring that the financial statements are *comprehensible* to users, bear *fidelity* to the Government's actual short-, medium-, and long-term fiscal position, and are *useful* to hold the Government accountable.

To that end, we are mindful of guidance provided in the Public Sector Accounting Board Standards that:

- "As elected representatives of the public, legislators and councillors are the primary users of government financial statements. They grant authority to the government to administer public resources and financial affairs, and hold the government accountable for its financial administration";[2]
- Reliable financial statements possess the characteristic of "representational faithfulness", "which is achieved when the transactions and events affecting the entity are presented in financial statements in a manner that is in agreement with the actual underlying transactions or events";[3]
- Financial statement information should be relevant, which means that it possesses "predictive, feedback and accountability value".[4]

We believe that there are opportunities to enhance the quality and transparency of asset and liability reporting. Our comments focus on three areas for consideration: reducing the valuation volatility of balance sheet items and enhancing representational faithfulness; improving the presentation of the Government's operating results and financial position; and, ensuring continuity for meaningful technical analysis.

2. Reducing Valuation Volatility and Enhancing Representational Faithfulness

As noted in the Government's consultation paper, volatility associated with the valuation of unfunded public sector pensions and other future benefit obligations increased following the adoption of a new methodology for calculating the discount rate in 2018.[5] While the consultation paper acknowledges that this volatility is a "communications" challenge, we believe it more fundamentally reflects a flawed approach to calculating the appropriate discount rate for these liabilities.

The liabilities under consideration are not directly funded by the issuance of market debt. Hence, there is a disconnect between the current valuation of the liability and its ultimate cost. Moreover, the recent daily volatility in interest rates across the yield curve demonstrates that this is not a meaningful valuation approach that provides relevant information for predicting the ultimate cost of satisfying this obligation.

Recognizing the extremely remote probability of Government bankruptcy and the consequential premature wind-up of its pension plans, we would recommend that a "best-estimate" approach be adopted—similar in spirit to the approach used to project and value the Canada Pension Plan.[6] This would entail discounting future obligations using an average private sector forecast of the interest rate on long-term government bonds, with the ultimate rate being adjusted every three years.

For example, over the medium term (that is, the next five years), the discount rate would be set equal to the average private sector forecast of the Government of Canada 10-year benchmark bond rate from Finance Canada's survey. Over the long term, this rate would converge to its ultimate (or steady-state) rate, which would be based on expert judgement of the "best estimate". The ultimate rate assumption would be clearly presented alongside the average private sector interest rate forecast. This approach could be adopted within the current framework for recognizing actuarial losses or gains, or it could be introduced along with changes to the current framework.

Were this approach to be adopted, it would reduce annual valuation volatility and enhance representational faithfulness by ensuring that reported financial results would be more representative of ultimate costs. Most importantly, we believe it would also enhance the ability of parliamentarians to understand the financial statements, helping them to better fulfill their role to hold the Government to account for how it raises and spends public funds.

3. Improving Presentation of Operating Results and Financial Position

We believe that Finance Canada's Operating Balance concept has some merit in enhancing the ability of parliamentarians to understand the Government's actual fiscal undertakings in a given year. However, there is considerable scope for improvement.

While removing the impact of actuarial gains and losses would improve upon the current presentation, the retention of revenues from return on investments and public debt charges undermines this measure of the Government's discretionary fiscal position.

If the principal objective is to enhance transparency and accountability regarding planned and actual operating activities, we would recommend using a "primary balance" concept. The primary balance represents non-investment revenue, less program spending, excluding actuarial gains and losses. Such a measure would be more effective by providing a clearer indication of the Government's discretionary fiscal posture, as well as its immediate impact on economic activity. Further, it also constitutes a key metric for assessing fiscal sustainability. Indeed, PBO and other organizations use this concept in their fiscal sustainability assessments.

To provide an indicator of its overall financial position (as opposed to just the discretionary position), we would further recommend removing the impact of actuarial gains/losses from the budgetary balance and immediate recognition of full valuation gains/losses in "other comprehensive income". This approach would follow the current treatment of "other comprehensive income", which completes the stock-flow relationship from the budgetary balance to the federal debt.

Appendix A provides a proforma presentation of our recommended changes for the 2017-18 and 2018-19 fiscal years.

We note that removing actuarial gains/losses outside of the budgetary balance would appear to be consistent with the new Public Sector Accounting Board (PSAB) on financial statement presentation. These standards are set to come into effect in fiscal year 2021-22 to allow certain gains/losses outside of the annual deficit/surplus. As noted in the Government's discussion paper, "[a]ccording to PSAB, this presentation will help improve accountability by distinguishing financial performance arising from operating activities from the greater uncertainty associated with unrealized performance."[7]

4. Ensuring Continuity of Technical Analysis

If the Government decides to implement changes to the calculation and/or presentation of its financial statements, PBO recommends that the principal fiscal aggregates be restated to at least 2008-09 (therefore presenting one full economic cycle). We note that a similar period was adjusted in 2018 to reflect the new discount rate methodology. PBO also recommends that re-stated data used to arrive at revised fiscal aggregates also be made publicly available.

Such changes are necessary for the PBO and many other stakeholders to undertake meaningful technical analysis of the Government's fiscal position to the benefit of parliamentarians and Canadians. This includes the costing of existing and proposed programs. As such, it is an essential aspect of supporting legislators in vigorous parliamentary debate.

5. Recommendations

1. To reduce valuation volatility and enhance representational faithfulness:

   PBO recommends that a "best-estimate" approach be adopted—similar in spirit to the approach used to project and value the Canada Pension Plan—to value the Government's unfunded public sector pensions and other future benefit obligations.

2. To improve the presentation of operating results and financial position:

   PBO recommends using a "primary balance" concept that represents non-investment revenue, less program spending, excluding actuarial gains and losses as an indicator of operating results.

   PBO recommends removing the impact of actuarial gains/losses from the budgetary balance and immediate recognition of full valuation gains/losses in "other comprehensive income" as an indicator of financial position.

3. To ensure continuity of technical analysis:

   PBO recommends that the principal fiscal aggregates be restated to at least 2008-09 and that re-stated data used to arrive at revised fiscal aggregates be made publicly available.

We appreciate the opportunity to provide our views regarding the Government's proposed changes. It would be our pleasure to further discuss our recommendations.

Appendix A: Proforma Presentation of Financial Tables

Table A-1 Current presentation

$ billions	2017-18	2018-19
Total revenues	311.2	332.2
Program spending	308.3	322.9
Public debt charges	21.9	23.3
Total expenses	330.2	346.2
Budgetary balance	**-19.0**	**-14.0**
Other comprehensive income (loss)	-0.8	-0.2
Accumulated deficit	**671.3**	**685.5**

Sources: Public Accounts of Canada and Parliamentary Budget Officer.

Table A-2 Adjustments

$ billions	2017-18	2018-19
Total revenues (current presentation)	311.2	332.2
Less: returns on investments	1.3	1.8
Less: net foreign exchange	1.5	1.7
Total revenues (proposed presentation)	308.4	328.7
Program spending (current presentation)	308.3	322.9
Less: losses from employee future benefit plans	12.8	8.2
Program spending (proposed presentation)	295.5	314.7
Other comprehensive income (current presentation)	-0.8	-0.2
Plus: returns on investments	1.3	1.8
Plus: net foreign exchange	1.5	1.7
Plus: actuarial gains (losses)	-12.2	-39.2
Other comprehensive income (proposed presentation)	-10.2	-36.0

Sources: Public Accounts of Canada and Parliamentary Budget Officer.

Note: Losses from employee future benefit plans are PBO calculations.

Table A-3 PBO proposed presentation

$ billions	2017-18	2018-19
Total revenues	308.4	328.7
Program spending	295.5	314.7
Primary balance	**12.9**	**14.0**
Public debt charges	21.9	23.3
Total expenses	317.4	338.0
Budgetary balance	**-8.9**	**-9.2**
Other comprehensive income (loss)	-10.2	-36.0
Accumulated deficit	**670.7**	**715.9**

Sources: Public Accounts of Canada and Parliamentary Budget Officer.

Table A-4 Difference between PBO and Finance Canada presentations

$ billions	2017-18	2018-19
Total revenues	-2.8	-3.5
Program spending	-12.8	-8.2
Primary balance	n/a	n/a
Public debt charges	-	-
Total expenses	-12.8	-8.2
Budgetary balance	10.0	4.7
Other comprehensive income (loss)	-9.4	-35.8
Accumulated deficit	-0.6	30.4

Sources: Public Accounts of Canada and Parliamentary Budget Officer.

Notes

1. *Parliament of Canada Act*. Section 79.01.
2. Public Sector Accounting Standard 1000, section .16. Public Sector Accounting Board.
3. Public Sector Accounting Standard 1000, section .29. Public Sector Accounting Board.
4. Public Sector Accounting Standard 1000, section .28. Public Sector Accounting Board.
5. *Consultation Paper: Proposed Changes to Reporting Gains and Losses in the Government's Financial Results*. Government of Canada.
6. The Office of the Chief Actuary uses "best-estimate" assumptions that "are determined by examining historical long-term and short-term trends and applying judgment as to the extent these trends will continue in the future. These assumptions reflect the Chief Actuary's best judgement…". Projected rates of return on CPP investments are used to value the future contributions and benefit obligations. See the *30th Actuarial Report on the Canada Pension Plan, as at 31 December 2018*.
7. Ibid, Note 5.