

Pay-As-You-Go Pension Plans and Disclosures in Financial Statements:

The Case of Quebec

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Abstract

In the 1990s, Defined Benefit Pension Plans trust was legally challenged in Canada. The Court declared that the plans change from contract relationships to trust relationships. In 2001, the financial statements Pay-As-You-Go Pension Plan (PAYGPP) disclosure was challenged in a Quebec court by the participants of the government of Quebec's PAYGPP. The Auditor General accordingly qualified his audit report from the end of the fiscal year March 31, 1999 to 2003. In 2004, the Court agreed with the PAYGPP disclosures and the use of different actuarial methods to disclose a pension plan liability applicable to different entities.

Introduction

Public sector pension plans are unique in that the governments and bodies created and funded by these plans also sponsor them. The presence of public sector pension plans is determined by the governments operating them. However, a government may amend the rules, such as France did in 2010, required to operate public sector pension plans.

Historically, the requirements for the funding of many public sector pension plans were not based on the same criteria as those for the funding of private sector plans. In fact, until a few decades ago, some governments took the net cash flows from public sector pension plans, included them in their general revenues and spent them as public funds.

Some governments continue to do this.

Canada has a proud history of Defined Benefit Pension Plans (DBPPs). While few DBPPs exist outside of the public sector, they are relatively well-funded compared to many other countries and play a significant role in the country's overall retirement income strategy. Some provincial governments, for example those of Quebec and Manitoba, promise to share the benefits of retirees with definable pensions. They guarantee to pay current-period benefit payments. Although they assume the responsibility of ensuring this guarantee, they do not commit to fulfilling it via a funding pension trust.

In the 1990s, DBPPs were legally challenged in Canada. The employers wished to appropriate trust surpluses and the court decided that trust is a relationship one. Following this court decision, questions were presented by DBPP members to the government of Quebec about their Pay-As-You-Go Pension Plans (PAYGPPs). Some members took legal action against the government of Quebec. They argued that the government's consolidated financial statement did not state the total amount of its financial commitment and did not include the amount of its financial obligation regarding their PAYGPPs.

This paper uses the legitimacy theory to highlight the government of Quebec's financial statements which reveal the government's promise to share the benefits of retirees with the public sector DBPPs. That is to say, the pecuniary obligation for PAYGPPs, in contrast to public sector liability, is to disclose PAYGPPs in financial statements.

Legitimacy Theory

(Suchman, 1995, p. 574) states that “**Legitimacy** is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (emphasis in original).

(Hybels, 1995, p. 243) argues that good models in legitimacy theory must examine the relevant stakeholders and explains how each stakeholder “influences the flow of resources crucial to the organizations’ establishment, growth, and survival, either through direct control or by the communication of good will.”

Legitimacy theory offers a way to monitor critically entity disclosures. The government of Quebec’s PAYGPP financial statement disclosures offer insight regarding this. The knowledge gained could then be used to provide better and more useful information, such as decision-making by stakeholders. This would result in empowering the society so that it has greater control over and insight into the government’s allocation of resources. In addition, this understanding would provide a vehicle for engaging in critical public debates. It would also provide an ideal opportunity to examine the crucial link between legitimacy and resources.

Pay-As-You-Go Pension Plans (PAYGPPs)

PAYGPPs are pension plans which fund only the amount of current-period benefit payments. In most European countries, such as France and Germany, pensions are covered through PAYGPPs. Both the state and current employees contribute to the pensions of those who are retired. Those who are presently working pay a percentage of their income to provide for the pensions of the retired. For example, until 1977/1978, the contributions of employees, with the exception of the members of the Government and Public Employees Retirement Plan (RREGOPP), were included in the revenue of the government of Quebec, and each year the government included the payable benefits in its budgetary expenditures.

Quebec Pay-As-You-Go Pension Plan

The Quebec PAYGPP stipulates that the plan members and the employers share the cost of the pension. The members of the RREGOP, the Pension Plan of Peace Officers in Correctional Services (PPPOCS) and the government of Quebec share the cost of the pension benefits. These benefits are based on the formula used to determine all pension costs of previous employees. These contributions result in a percentage of the total pension benefits. Although the government is not required to capitalize its share in pension plans, it is legally locked into its plan.

Excerpts from the government of Quebec consolidated financial statements

(Gouvernement du Québec, 1999, p. 18) note:

5. PENSION PLANS

Cost-sharing pension plans

In the case of RREGOP, the Government covers costs at a rate of 50% for years of service since July 1, 1982 and 58.33% (7/12) for years of service prior to July 1, 1982. The contributions of participants and independent employers to RREGOP are paid into the *Caisse de dépôt et placement du Québec*.

In the case of the PPPOCS, the Government covers 46% of costs, while employees cover 54%. Employee contributions are paid into the Consolidated Revenue Fund.

The *Commission administrative des régimes de retraite et d'assurances (CARRA)* manages the pension plans entrusted to its administration by the government of Quebec. It also provides its expertise for the actuarial valuations of pension plans and the investments of the funds entrusted to the *Caisse de dépôt et placement du Québec* (CDPQ).

The Public Sector Accounting Board (PSAB)

The Public Sector Accounting Board (PSAB) develops, recommends and approves of accounting and financial reporting standards in the public sector. These standards, as formulated by the Canadian Institute of Chartered Accountants (CICA), are constantly being revised.

The PSAB has published a series of new recommendations on the methods of accounting and presentation for government commitments with respect to employee retirement plans. While governments are not obliged to comply fully with the recommendations of the PSAB, the Auditor General relies on these standards to assess the compliance of government accounting policies.

Quebec Accounting Policies

Over the past forty years, the accounting policies of the government of Quebec have undergone five major changes. First, in 1971, the government of Quebec announced changes to its accounting policies. The main change was the introduction of net debt. Second, in 1978, the government introduced changes to the treatment of the accounting of retirement plans. This change occurred in order to take the actuarial liability into account and to amortize it in government expenditures over a fifty-year period. Third, in 1986 and 1987, the government of Quebec presented changes in the consolidation of the results of its capital stock corporations in its financial statements and in the methods of evaluating commitments with respect to retirement plans. Fourth, in 1998, the government modified its accounting policies and adopted the recommendations of the PSAB regarding retirement plans, tangible assets, public sector restructuring measures, loans and the presentation of consolidated financial statements. Last, in 2007, the government of Quebec revised its accounting policies so as to comply with Generally Accepted Accounting Principles (GAAP) applicable to the public sector. These policies are based on the suggestions of the CICA.

The Case of PAYGPPs in Quebec

Since the fiscal year 1997/1998, the government of Quebec has disclosed its “Pay-As-You-Go” pension commitment, according to the recommendations of the PSAB, regarding pension plans in its consolidated financial statements. By doing so, the government has followed the recommendations of the Study Committee on Government Accounting report (Study Committee on Government Accounting, 1998, p. 10) and has recorded its liability following the recommendations of the CICA for public sector pension plans.

Members of some PAYGPPs disputed this disclosure due to their interpretation of article 176 of the RREGOP¹ Act. Their main argument was that the liability presented in Quebec’s consolidated financial statements did not acknowledge the debt in the pension plan.

The Position of Pension Plan Members

The pension plan of these members has been under the RREGOP Act since July 1, 1973. This pension plan is a DBPP, and its costs are shared between the participants’ plan and

the government. The members pay into the plan and capitalize their contribution share in the pension plan trust to meet their liability.

On March 31, 1997, the RREGOP reported an actuarial surplus of \$3.9 billion, i.e., \$1 billion for the plan of non-union employees and \$2.9 billion for the plan of union employees. This surplus is mainly the result of actuarial gains and losses, as well as adjustments made to actuarial assumptions. However, an amendment to the Act respecting the RREGOP stipulates that the retirement plan for non-union employees, which had been evaluated on the basis of the balance of the cost up until December 31, 1996, should be evaluated on a shared-cost basis as of January 1, 1997 in the same manner as the plan for union employees. This legislative amendment created an actuarial deficit of \$1 billion on April 1, 1997.

From 1999 to 2001, discussions were under way to reach an agreement on the interpretation of article 176 in the RREGOP. On December 17, 2001, the *Regroupement des associations de cadres en matière d'assurance et de retraite (RACAR) et al.* filed for a motion for declaratory judgment and *in mandamus* in the Quebec Superior Court. By said motion, the plaintiffs requested that the court recognize that the government has certain obligations within the framework of the Act respecting the RREGOP with regards to the Pension Plan of Management Personnel (PPMP).

In terms of the accounting, the motion for declaratory judgment asked the court to:

- DECLARE that the government, as an employer, fails to take into account in its financial statements the totality of its financial obligations under the Act respecting the Government and Public Employees Retirement Plan (RREGOP);
- DECLARE that the government fails to correctly include in its financial statements the amount of its financial commitments with regards to the cost of: a) the RREGOP; b) the PPPOCS; and c) the partitions provided for in pertaining laws, in particular, article 176 of the Act respecting the government and public employees' retirement plan.

The Position of the Auditor General of Québec

Since 1995-1996, the Auditor General has asked that the accounting policy on retirement plans follow the recommendations of the PSAB. The change of pension plan disclosure occurred in the 1998 Quebec consolidated financial statements. The Auditor General signed a standard auditor report for that year. Thereafter, he qualified his auditor report regarding the RREGOP and PPPOCS pension plan disclosure from 1999 through 2003 although the financial statements complied with the recommendations of the CICA for public sector pension plans. Since 2004, he has not qualified his report on this pension plan disclosure.

From 1999 to 2003, the Auditor General of Quebec stated that the government had a commitment to finance the RREGOP and PPPOCS. In addition, the government should commit to calculating the expenditures for the fund that it would have amassed if it had been required to pay contributions since 1973 in a trust plan. The calculations should

follow the same standards as those used to determine the rate of contributions of the participants.

The Auditor General qualified his audit report for the financial statements of March 31, 1999². The following is an excerpt of the Auditor General's report (December 17, 1999):

COMMITMENTS FOR THE RÉGIME DE RETRAITE DES EMPLOYÉS DU GOUVERNEMENT ET DES ORGANISMES PUBLICS (RREGOP) AND THE RÉGIME DE RETRAITE DES AGENTS DE LA PAIX EN SERVICES CORRECTIONNELS (PPPOCS)

In note 5 of its financial statements, the government does not clearly recognize that it has contracted commitments for the financing of these plans. Indeed, it does not indicate that the commitments to which reference is made ensue from the sharing of the annual contribution established according to the legislative provisions of these plans and the collective agreements that the government has negotiated since the creation of the plans. With respect to commitments of \$29,542 million and \$560 million for the RREGOP and the PPPOCS respectively, \$16,751 million and \$480 million are already recorded under liabilities as of March 31, 1999.

Although these commitments had no effect on the liabilities, the net debt and the surplus of the year ended March 31, 1999, this information must be disclosed appropriately to enable readers of the financial statements to better evaluate the government's financial condition.

Judgment

The hearing took place on April 30, 2004. The judgment³ was delivered on July 15, 2004.

The court addressed the motion for declaratory judgment as a dispute over contract interpretation, specifically, the interpretation of article 176 of the RREGOP Act.

Although the RACAR represents many union members, the judge specified that the only plaintiffs of this motion for declaratory judgment and *in mandamus* in The Québec Superior Court are management employees, i.e., non-union employees and Peace Officer/Correctional Service Workers.

All parties agree that the government: a) has an obligation regarding the Act respecting the RREGOP and its regulatory act; b) has fulfilled its financial commitments in regards to the cost of the RREGOP, as well as that of the PPPOCS; c) has fulfilled its financial obligations under the RREGOP; and d) is not required to fund its part of the RREGOP.

The court did not agree on the motion for declaratory judgment and

- DECLARED that during the fiscal years, 1973 -1987/88, 1989-1997/98 and 1999-present, the government has properly divulged its financial obligations according to the standards of the CICA pertaining to the shared cost of the RREGOP, the *Régime de retraite du personnel d'encadrement (RRPE)* and the PPPOCS. The partition costs are provided for in the acts concerned, more specifically, in article 176 of the RREGOP Act.

The government does not pay contributions to the pension plan because it is not legally obliged to do so. Moreover, it does not have such a pension plan trust. However, the government is legally required to report its pension plan obligations in its financial statements

The judge also

- DECLARED that the shared cost in financing the pension plans of the RREGOP, the RRPE and the PPPOCS does not require the government to use the same actuarial basis as the one used to establish an employee's member pension plan, in that case CARRA, particularly as it is proven that the legal pension estate of each employee's member is not at risk of being adversely affected.

The judge justified his position by citing the verdict of Cory, the Supreme Court judge:

An ongoing pension fund is said to have an "existing" or "actuarial" surplus when the estimated value of the assets in the fund exceeds the estimated value of all of the liabilities (i.e., pension benefits owed employees) of the fund. When the calculated fund liabilities exceed the calculated fund assets, the plan is said to be in a state of "unfunded liability". Once the plan is wound up, assets and liabilities can be precisely determined. The fund will then be in a state of "actual" or "real" surplus or liability. (Schmidt v. Air Products Canada Ltd. [1994] 2 S.C.R. 611, 1994, p. 19)

He claimed that both actuarial estimates are acceptable because the real pension plan finance will only be known when the plan is wound up. Once again he cited the verdict of Cory, the Supreme Court judge:

Contribution to a defined benefit plan is made each year on the basis of an actuary's estimate of the amount which must be presently invested in order to provide the stipulated benefits at the time the pension is paid out. The actuary's estimate of the present value of future benefits to members of the plan is known as the "current service cost". The obvious difficulties involved in predicting factors such as inflation rates, investment returns and the future employee levels of the company mean that the actuary's task is difficult and to a certain extent speculative. The assumptions made by actuaries in respect of these and other factors will have a significant impact upon the determination of current service costs and the calculation of present levels of fund surplus or liability." (Schmidt v. Air Products Canada Ltd. [1994] 2 S.C.R. 611, 1994, p. 19)

He also specified that the purposes of the government's financial statements are general while those of the CARRA are specialised.

The Government's Responses

The government of Quebec disclosed in its financial statements note its commitment to funding. The funding is to be calculated as the funds that the government would have amassed had it been required to pay contributions since 1973 using the same standards as those used to determine the participants' rate of contribution. Moreover, under the Financial Administration Act (R.S.Q., c. A-6, Division VII.I), the government of Quebec may make long-term investments, by way of a deposit with the CDPQ, up to an amount equal to the sums recorded in the retirement plans account. While the government is not required to capitalize its share in the pension plan, it has invested in a Retirement Plans Sinking Fund. The purpose is to provide for the payment of all or part of the benefits awarded under its PAYGPP commitments. The sinking fund's assets are recorded at their market value. Although this sinking fund is not legally linked to any pension plan, the government of Quebec has partially capitalized it.

Discussions

Government legitimacy does not arise from merely abiding to legal requirements. Instead, reference to the prevailing norms and values of society is fundamental in ensuring its bestowed legitimacy.

The government remains fully responsible for ensuring disbursement in a timely manner according to its promise although it only committed to paying benefits. Its PAYGPP is a commitment in a contract relationship. Insolvency risk is almost non-existent. The tendency of courts to interpret the funded pension “deal” as a classic trust rather than as a contract or business trust does not apply to a PAYGPP. As with other compensations pursuant to the intent of parties which negotiate pension plans, factors involving a PAYGPP should be viewed more in the context of a “**contract**” rather than a “**relationship.**”

The financial benefits of a PAYGPP may not reflect the economic benefits although the future economic benefits have sometimes been used in accounting texts to signify access to future cash inflow. There are a number of key factors currently not at play with a government PAYGPP. These factors include financial market fluctuations, the absence of employers’ income tax, solvency issues, and intergenerational equity.

Generally, public sector plan sponsors are self-governing public sector agencies or crown corporations that are at arm’s length from the core public service, but are not subject to the rigours or risks of free market competition. A PAYGPP protects its members and beneficiaries from some financial risks as is no fund invested in the market.

Concerns on the part of pension plan members and beneficiaries regarding the security of their pension benefits are caused in part by the amount of public media coverage of high profile pension plans with large deficits. Many analysts and observers in the financial community are of the opinion that current pension plan funding standards are inadequate. This is indicated by the statistically high number of pension plans with financial deficits which do not play a role in a PAYGPP. On the contrary, pension plan members and beneficiaries are concerned about the power government holds when making changes to pension rules. They are particularly worried about changes the government may choose to implement during an economic crisis.

The government does not pay income tax and the public sector plans have little need for tax deductions on their contributions. Consequently, no tax leakage would result from exempting either of them from these rules (Income Tax Regulations). The wording of standard plans, which was imposed by the tax regulator in the distant past regarding the irrevocability of assets and solvency issue, did not reflect the PAYGPP “promise” and, hence, does not apply.

The solvency issues are irrelevant and should not be applied to the public sector that includes public sector agencies and crown corporations, and pension plans. Due to a public policy that presumes a continuity plan, entitlements for public sector pension plans have often not been specified even though, in reality, the employer will not become insolvent and will be unable to make future contributions. The absence of solvency risk

would be consistent with the way many governments regulate their equivalent public sector plans when covering hospitals, municipalities, schools and colleges, and would be fairer to taxpayers.

There are numerous public policy reasons for establishing public sector entities with the governance being at arm's length from the central government, but exposing their budgets and their employees' pensions to solvency risk is not one of them. To the contrary, pension standards acts ought to recognize the solvency risk through risk-based funding rules that recognize the inherent security and stability of the public sector. Although solvency is not an issue for many public sector plans, the requirement for a solvency valuation for these plans results in, at best, unnecessary work and expense. However, it is, in fact, likely to cause real problems. It does not make sense to run the risk of the breakdown of labour relations over a hypothetical situation that is extremely unlikely to ever occur. There is also the question of fairness to taxpayers. Imposing a requirement to make solvency deficiency amortization contributions to public sector plans costs taxpayers money, yet offers no benefits and presents no risks. The logical outcome is that taxpayer funds can be better utilized at no increase in risk to plan members.

Although the Association of Canadian Pension Management (ACPM) report recommends the solvency valuation as the minimum funding requirement valuation, it suggests there may be instances where it is more appropriate for minimum funding requirements to be based upon the going concern valuation. For example, while jointly sponsored plans in

the public sector have little or no chance of plan termination, the underlying premise of solvency valuations is that their primary objectives are of intergenerational equity and contribution rate stability for members and employers, both of which might be better measured in a going concern valuation. Considering the near absence of insolvency risk for employers in the public sector, we suggest that the focus should be on avoiding excessive inter-cohort and intergenerational inequity among taxpayers.

Where the PAYGPP benefit constitutes the basic deal, there should not be constraints on changing the benefit provisions for future service based on inter-cohort and intergenerational equity considerations. However, for public sector plans, avoiding excessive intergenerational inequity among taxpayers should be another objective. Meeting this objective calls for the period allowed for the payment of funding deficits of public sector plans not to be too long so as to avoid an unreasonable transfer of costs between generations of taxpayers. A debt occurs when there is intergenerational inequity among taxpayers even when a deficient inequity is not an asset.

Conclusion

Legitimacy Theory provides the theoretical basis for understanding how and why the government might use externally-focussed disclosure reports to enhance its reputation and manage risk. There appears to be very strong relationships which are inextricably

linked between the notions of ‘legitimacy,’ ‘social contract’ and ‘government disclosure policies.’

Given the time frames involved and questions considered, the current business environment, including when capitalist structures, democratic governments, etc., are taken as a given, the research is situated in a static context. This assumption would, however, need to be carefully considered in a longitudinal study of significant length.

The case of the government of Quebec illustrates that the CICA standard has been confirmed as a means to disclose the pension plan. The government must disclose within its financial statements, or by some other means, its participation in the funding of the pension plan.

The case of the government of Quebec demonstrates that a different actuarial method can be used to disclose the same pension plan liability. The government and CARRA have the same participants, but use different actuarial hypotheses to determine their participants’ funds.

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¹ Gouvernement Du Quebec (2010), 'An act respecting the government and public employees retirement plan', in, *R.S.Q. chapter R-10*, (Gouvernement du Quebec, Canada).

176. The cost of the Government and Public Employees Retirement Plan is, from 1 July 1982, shared equally between the employees and the employers.

In the case of the Teachers Pension Plan and the Civil Service Superannuation Plan, the difference between the cost of the plan and the contributions paid by the teachers or officers, as the case may be, within the meaning of those plans, shall be assumed by the employers.

1983, c. 24, s. 1; 1989, c. 76, s. 3; 1992, c. 39, s. 36.

(http://www2.publicationsduQuebec.gouv.qc.ca/dynamicSearch/telecharge.php?type=2&file=/R_10/R10_A.html), as 11 01 06)

² Gouvernement Du Quebec (1999), 'Public accounts 1998-1999', in M. D. Finances (ed), (Gouvernement du Quebec). p.5.

³ Regroupement Ass Cadres En Matiere Ass & Retraite Et Al C. Procureur General Du Quebec Et Al C.S. No 200-05-016281-011 (15-07-2004), in.