Summary of GASB's Preliminary Views on Pension Accounting and Financial Reporting by Employers

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Agenda

- Background
- Current Employer Standards
- Preliminary Views
- Conclusions

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GASB Standards Background

- Established in 1984, the GASB is an independent, nonprofit organization and is the recognized authority for governmental accounting and financial reporting standards in the U.S.
- GASB has no authority to enforce the standards; however, auditors apply the standards in performing financial audits of state and local governments.
- If the standards aren't followed, the auditor notes this in its audit letter which, in turn, may affect the interest rates that the government pays on future debt.
- Many states have statutes requiring their governments to follow the GASB standards.

Background Leading to Preliminary Views

- GASB decided in 2006 to review financial reporting by and for pension and postretirement benefits plans in the U.S. to ensure that existing standards continue to be appropriate.
- The project began in earnest in 2008 with a review of existing standards and previously received criticism.
- In March 2009, GASB issued an "invitation to comment" on the existing standards.
- GASB reviewed the responses and formulated tentative decisions which formed the basis of the Preliminary Views.
- GASB will review feedback on the Preliminary Views and issue an Exposure Draft.

- The primary objective is to present the GASB’s current views on employer recognition and measurement of pensions in order to obtain comments before developing more detailed proposals for changes to the existing standards.
- The PVs represent basic principles or concepts rather than detailed potential requirements.
- They cover accounting and financial reporting for pension benefits; they have no bearing on the funding or financing of such benefits.

Current GASB Pension Standards

- The GASB's current pension standards can be seen as consisting of three subsets:
  - Statement No. 27 provides two sets of standards for employers that sponsor pension plans:
    - Employers in sole and agent multiple-employer plans
    - Employers in cost-sharing plans
  - Statement No. 25 provides one set of standards for pension plans:
    - Sole, agent multiple-employer, and cost-sharing multiple-employer plans
- The GASB has decided to initially focus on the standards for employers (Statement No. 27).

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- Current accounting standards also draw a distinction between recognition and disclosure:
  - Items are recognized in the basic financial statements:
    - Statement of Net Assets (e.g., assets, liabilities)
    - Statement of Activities (e.g., revenues, expenses)
  - Items are disclosed in the Notes to the Financial Statements and Required Supplementary Information
    - Plan description
    - Schedule of funding progress
    - Schedule of employer contributions
- The GASB has decided to focus on items recognized in the employer's basic financial statements.

Focus of Preliminary Views

- The focus of the Preliminary Views is on recognition in a governmental employer's basic financial statements of the following:
  - pension liability, and
  - pension expense
- Other issues will be addressed separately, including:
  - accounting and reporting for pension plans,
  - note disclosures, and
  - other postemployment benefits (OPEBs)

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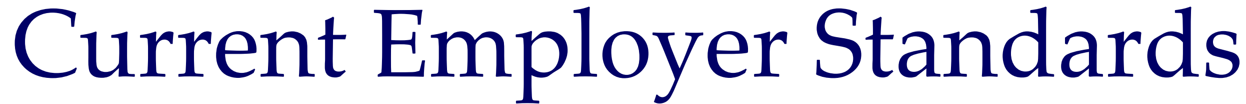
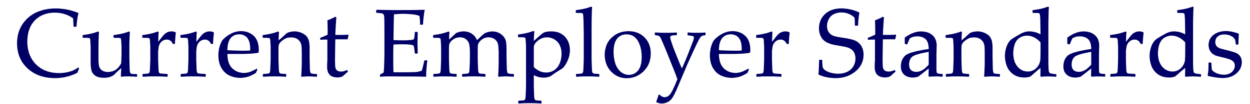


Current Employer Standards

- For employers sponsoring **sole and agent plans**:
  - Pension Expense = Annual Pension Cost
    - Reflecting the actuarially determined "annual required contributions" (ARC), adjusted to reflect interest on contributions that are greater or less than the ARC
  - Pension Liability = Net Pension Obligation
    - Reflecting the accumulated difference between annual pension costs and actual employer contributions made since the effective date of Statement 27
- Current actuarial valuation parameters:
  - Six allowable actuarial cost methods
  - Discount rate reflects expected long-term investment returns
  - Actuarial gains/losses amortized over a maximum of 30 years



Current Employer Standards

- For employers in **cost-sharing plans**:
  - Pension Expense = Contractually Required Contribution
    - Reflecting the contractual contribution of the employer to the cost-sharing pension plan
    - But not necessarily reflecting the actuarially determined contribution to the plan
  - Pension Liability = the difference between the employer's contractually required contributions and contributions actually made

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Preliminary Views

The Employment Exchange

- A sole or agent employer incurs a pension obligation as a result of the "employment exchange"
- In the employment exchange, employees offer services to the employer and the employer offers salaries and benefits
- Deferred benefits, including pension benefits, are part of the exchange

- The pension plan is primarily responsible for paying the pension benefit to the extent the plan has accumulated sufficient assets.
- The employer is secondarily responsible to the extent the plan has sufficient assets.
- The employer is primarily responsible to the extent the plan does not have sufficient assets.

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- Under GASB Concepts Statement No. 4, a liability is a present obligation that the employer has little or no discretion to avoid and that requires the sacrifice of resources.
- Preliminary Views:
  - The "unfunded pension obligation" (referred to as the *net pension liability*) to employees for which the employer is primarily responsible meets the definition of a liability.
  - Further, it is measurable with sufficient reliability to **be recognized in an employer's basic financial statements.**

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Net Pension Liability

- The net pension liability (NPL) includes projected future benefits related to:
  - Automatic cost-of-living adjustments (COLAs);
  - Ad hoc COLAs, to the extent they are not substantively different from automatic COLAs;
  - Projected future salary increases; and
  - Projected future service credits.
- The net pension liability is equal to:
  1. The employer's total pension liability, less
  2. The amount of accumulated plan assets calculated as of the end of the financial reporting period (MV).
- For WRS, NPL would be approximately $8 billion as of 12/31/2009.

- The discount rate should be the single rate that produces a present value equivalent to that obtained by discounting projected benefit payments using:
  - The long-term expected return on plan assets to the extent that current and expected future pension plan assets are sufficient to pay projected future benefits
  - A high-quality municipal bond index rate (e.g., 4.5%) for future benefit payments beyond the point at which current and expected future pension plan assets are projected to be depleted

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Actuarial Cost Method

- For purposes of determining the total pension liability of an employer as well as determining the service cost component of pension expense, the present value of projected benefit payments should be allocated to past and future periods using the entry age actuarial cost method applied on a level percentage of pay basis.
- Attribution should be over each employee's projected period of service.

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Pension Expense – Amortization of Liability Changes

- Changes in the employer's net pension liability due to the following should be recognized in the pension expense over the remaining service lives of individual plan members:
  - Differences between assumed and actual experience with regard to demographic and economic factors;
  - Effects of changes in economic and demographic assumptions; and
  - Effects of benefit changes that are applied retroactively to past periods of service.
- Changes in liability related to past periods of service for inactive members (including retirees) should be recognized immediately.

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Pension Expense – Related to Investment Earnings

- Investment earnings above or below the expected long-term return should be deferred (not included in the pension expense) so long as –
  - The net cumulative amount of the deferred outflows (or deferred inflows) remains within a corridor 15% above and below the reported (market) value of plan net assets.
- If the net cumulative deferred balance falls outside the corridor, the amount outside the corridor should be recognized immediately in the pension expense.

- Employers in cost-sharing plans should recognize their "proportionate share" of the plan's collective net pension liability, pension expense, and deferred pension expense.
- The cost-sharing plan should calculate these measures using the same methods as used for sole and agent plans.
- Changes in an employer's net pension liability due to changes in the employer's "proportionate level of participation" compared to the prior period should be recognized in the employer's pension expense for the current period.

Cost Sharing Example 1

Two Employers:

Net Pension Liability = $1,000

Pension Expense = $100

Year 1	Payroll	Payroll %	Net Pension Liability	Pension Expense	Contractual Contribution
Employer 1	$ 250	25%	$ 250	$ 25	$ 25
Employer 2	$ 750	75%	$ 750	$ 75	$ 75
Total	$1,000	100%	$1,000	$100	$100

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Net Pension Liability = $1,000

Pension Expense = $100

Employer 2 has reduction in payroll due to layoffs

Year 2	Payroll	Payroll %	Net Pension Liability	Pension Expense	Contractual Contribution
Employer 1	$250	33%	$ 333	$ 33	$ 25
Employer 2	$500	67%	$ 667	$ 67	$ 50
Total	$750	100%	$1,000	$100	$75

Cost Sharing Example 2

Employer 1 has retirees only

Employer 2 has actives and retirees

	Payroll	Payroll %	Market Value	Actuarial Liability	Net Pension Liability	Pension Expense
Employer 1	$ 0	0%	$2,500	$2,000	$ 0	$ 0
Employer 2	$1,000	100%	$2,500	$2,000	$1,000	$100
Total	$1,000	100%	$5,000	$4,000	$1,000	$100

Minimum Measurement Frequency and Timing

- A full measurement of the employer's pension liability should be made at least once every two-years. (Biennially)
- The employer's liability measurement need not be at fiscal year end; however it should be done no more than 24 months before the end of the fiscal year.
- If the full measurement of the employer's liability is not done at fiscal year end, it should be updated to the fiscal year end, with the update reflecting all significant changes since the last comprehensive measurement.
- The value of plan assets should reflect plan net assets as of the employer's fiscal year end.

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Employers with Fiscal Year January 1, 2011 – December 31, 2011:

- MV determined as of December 31, 2011 based on actual assets
- Liabilities measured from December 31, 2010 valuation, rolled forward to December 31, 2011 and adjusted for any significant events
- Net Pension Liability and Pension Expense calculated in total
- Net Pension Liability and Pension Expense then allocated to individual employers based on payroll
- Note – actual funding contribution is determined from December 31, 2009 valuation

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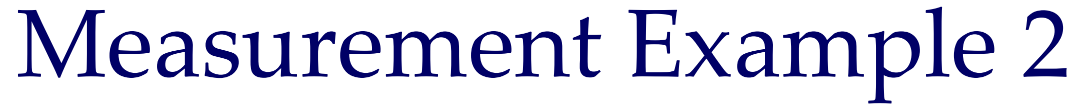

Measurement Example 2

Employers with Fiscal Year October 1, 2011 – September 31, 2012:

- MV determined as of September 30, 2012 based on actual assets
- Liabilities measured from December 31, 2011 valuation, rolled forward to September 30, 2012 and adjusted for any significant events
- Net Pension Liability and Pension Expense calculated in total
- Net Pension Liability and Pension Expense then allocated to individual employers based on payroll
- Note – actual funding contribution is determined from December 31, 2009 valuation

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Summary of Major Changes

- Accounting and funding are decoupled. The GASB 27 "ARC" had become a de facto funding standard. With the PV, there would be no such standard.
- A measure of the unfunded pension liability (or net pension liability) is included on the employer's financial statement rather than solely in the supplemental information. It would be based on market value and would tend to be volatile.
- For purposes of calculating the annual pension expense, changes in pension liabilities are amortized over shorter periods of time.

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Summary of Major Changes

- Some plans will be able to continue using the long term expected rate of return on assets as the discount rate. Others, depending on the sufficiency of their assets and future contributions may have to use a blend of that rate and a high quality municipal bond rate.
- The entry age actuarial cost method must be used.
- Employers participating in cost sharing plans are required to recognize a proportionate share of net pension liability, and expense calculated in the same manner as sole and agent employers.

	Current Standards	Preliminary Views
Liability Reflected on Balance Sheet	Only the accumulated difference between the GASB 27 "annual pension cost" and contributions actually made	The "unfunded pension obligation" (referred to as the *net pension liability)*

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	Current Standards	Preliminary Views
Annual Pension Expense	1. Normal cost, plus 2. amortization of the unfunded liability (over a max of 30 years), plus 3. adjustments	1. Entry Age Normal Service cost, plus 2. Interest on the entry age actuarial liability, minus 3. Expected return on plan assets, plus 4. Cumulative unrecognized investment gains or losses outside the 15% corridor plus 5. amortization of changes in the entry age normal liability due to gains and losses, changes in assumptions, and changes in plan benefits*

*Amortization over expected remaining service lives of employees

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- Written comments are definitely encouraged and are due to the GASB by September 17, 2010.
- GASB has scheduled three public hearings:
  - October 13, 2010 in Dallas,
  - October 14, 2010 in San Francisco, and
  - October 27, 2010 in New York City.

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Conclusions

- The changes proposed in the PVs represent a significant departure from the current pension accounting and financial reporting standards.
- The changes also appear to represent a decoupling of pension expense and pension funding for employers whose current funding policy is linked to the GASB 27 ARC.
- The changes could potentially require public sector pension plans to have two separate actuarial valuations completed – one for funding and one for accounting.

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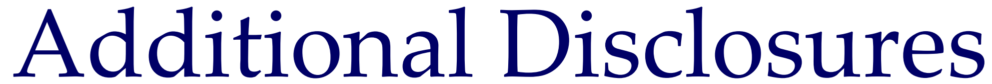
- The creation of separate accounting and funding "numbers" may cause additional confusion about the "real" costs and funded status of public pension plans.
- The PVs if adopted may increase the size of reported pension liabilities and expenses in the employer's financial statement.
- The PVs if adopted will create additional complexity for employers in cost sharing plans.



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