

GASB Exposure Drafts on Pension Accounting and Financial Reporting

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On July 11, 2011, the Governmental Accounting Standards Board (GASB) issued Exposure Drafts (ED) of the proposed amended Statement Nos. 25 and 27 covering the *Financial Reporting for Pension Plans* (No. 25) and *Accounting for Pensions by State and Local Governmental Employers* (No. 27). The proposed amendments represent a significant shift from the current policies in accounting for public employee pension plans. Plan sponsors, administrators, trustees and other interested parties involved in public pension plans should study the proposed amendments to the Statements and make their concerns and opinions known to GASB. The comment period ends September 30, 2011.

Introduction and Background

The Exposure Drafts released by GASB are the next step in a long-running project that began early in 2006. GASB issued an Invitation to Comment in March 2009 and released their Preliminary Views (PV) document in June 2010, followed by another request for comments. This project is intended to reexamine current accounting standards detailed in GASB Statement Nos. 25 and 27. Following the Board's consideration of comments on the exposure drafts, they are expected to issue final amended statements. We encourage all parties to provide GASB their comments and concerns by the September 30, 2011 deadline.

This paper provides our comments on specific concerns raised by the amendments. As an actuarial consulting firm heavily engaged in providing services to public sector pension and OPEB plans, we have several concerns with the direction GASB is taking with the proposed amended statements for financial reporting, the implications of the divorce of accounting and funding for pensions, and the degree of effort and expense required to comply with the proposed amended statements.

Significant Changes in the Proposed Amendments

Reporting of Net Pension Liability in Financial Statements

One of the most significant changes in the proposed amendments is the reporting of the *net pension liability* in the employer's financial statements. The net pension liability is basically the difference between the present value of the projected benefits allocated to

the period of service performed prior to the fiscal year-end (called the *total pension liability*) and the market value of the plan's net assets at fiscal year-end (called the *plan net position*). The allocation of the present value of benefits in determining the total pension liability is performed using the entry age normal actuarial cost method regardless of the cost method used in actuarial valuation calculations of the plan for funding purposes. For a typical plan that is expected to receive actuarially sufficient contributions in the future, this determination of the net pension liability is similar to the plan's unfunded accrued liability determined using the market value of plan assets rather than the smoothed actuarial value.

The proposed amendments allow for the use of the plan's assumed rate of investment return in determining the total pension liability provided the market value of the plan's net assets and expected future contributions are sufficient to satisfy the payment of all projected benefits for current active and retired members.

If assets were projected to be depleted in the future, the proposed amendments would require the determination of a blended discount rate. This rate is the single rate that produces the same present value of benefits as using the plan's assumed rate of investment return for projected benefit payments until the asset depletion occurs and a high-quality 30-year tax-exempt municipal bond index rate for discounting the projected benefit payments made after asset depletion occurs. In these cases, and in cases where a plan's actuarial value is much larger than the market value, employers will report on their financial statements a liability significantly larger than the plan's unfunded accrued liability.

Determination of Annual Pension Expense

Another major change in the proposed amended statement No. 27 is the determination of the annual pension expense. Whereas under current statements the annual pension expense is based upon the annual required contribution and adjusted only for the existence of a net pension obligation or asset, the proposed amendments would calculate the annual pension expense as basically the change in the net pension liability.

GASB specifies the period over which changes to the net pension liability are to be recognized as pension expense based upon the source of the change. The following sources of change in the net pension liability are to be immediately recognized in the annual determination of pension expense: the employer's portion of the plan's normal cost (called service cost), the annual amount of interest on the beginning of the year total pension liability, changes to plan benefits, expected investment earnings on the plan's assets, non-investment changes to plan assets (benefit payments, contributions, administrative expenses, etc.), actuarial experience gains and losses attributed to non-active members, and changes in the total pension liability attributed to non-active members due to changes in actuarial assumptions.

Other sources of change in the net pension liability attributable to active members, such as actuarial experience gains and losses and the change in the total pension liability due to changes in assumptions, are recognized over the weighted average working lifetime of the active members. The remaining source of change in the net pension liability is due to the difference between actual and expected investment returns, which are recognized over a closed five-year period.

Given the more rapid recognition of changes in total pension liability, it should be expected that pension expense will be more volatile than under the current statements. For employers in cost-sharing plans, perhaps the most significant proposed change is that the cost-sharing plan's net pension liability and pension expense are to be allocated to each participating employer to be reported on their financial statements. This will require a good deal of effort and expense in order to allocate the collective net pension liability and pension expense to each employer in accordance with the procedure put forth in the EDs.

Divorce of Accounting and Funding

Unlike the "funding-friendly" standards in place under current Statements 25 and 27, the exposure drafts of the amendments to the Statements represents a complete divorce of accounting and funding. As GASB stated in the Preliminary Views (PV): "It is not within the scope of the Board's activities to establish standards with regard to a government's method of financing the benefits it has obligated itself to provide (that being a policy decision for government officials or other responsible authority to make) or to regulate a government's compliance with the financing policy or method it adopts. Accordingly, the proposals put forth in the Preliminary Views are made solely within the context of accounting and financial reporting, not within the context of the funding of pension benefits."

There are several concerns raised by this divorce. The development of the Annual Required Contribution (ARC) in compliance with the parameters of the current statements provides contributing entities with an actuarially determined, reasonable funding measure for ensuring at least a minimum acceptable degree of funding progress. If employers commit to funding the full ARC, no liability is placed on their balance sheets and pension expense is equal to their required contribution amount to the pension plan. This intuitive outcome is the carrot in the carrot and stick analogy. The stick is the requirement placed on contributing entities that fail to contribute the full ARC to disclose the accumulated funding deficiency (called Net Pension Obligation or NPO) as a liability on their balance sheets.

The marriage of accounting and funding in the current statements allows for all interested parties and professionals serving the plans and employers to have a common language and understanding of the implications of funding decisions made by the contributing entities. More importantly, it provides meaningful incentives that promote adherence to actuarially sound funding policies. This can easily be seen in the number of government employers that have decided to begin prefunding other postretirement benefits (OPEB) under the similar GASB statements applicable to those benefits (Statement Nos. 43 and 45). The incentive to minimize the impact to their balance sheets due to net OPEB obligations (similar to the NPO) resulted in many employers funding OPEB in excess of the pay-as-you-go cost.

Further, the use in the current statements of the terminology – *Annual Required Contribution* – and its consistent applicability to both funding and accounting resulted in the widespread use and understanding of the term throughout the pension industry and governments. Additionally, the other actuarial information prepared in the funding valuation and disclosed as required supplemental information, such as the plan’s funded ratio, became visible and better understood by decision makers.

Finally, the marriage of accounting and funding resulted in discussions concerning public pensions to be typically based on a single and consistent valuation result. Looking back to the years prior to the issuance of GASB Nos. 25 and 27, GASB Statement No. 5 provided that the accounting disclosure for pensions be based upon a valuation methodology that was not commonly used and therefore produced a different measure of the pension’s funded status than the valuation results used for funding.

It was common for the discussions to be based upon two different valuation results and the result that best supported one side’s argument over another would be used as its basis. Comments noted from respondents to the GASB Nos. 25 and 27 exposure drafts point out the problems with having material differences between the accounting and the funding results and include:

- The accounting measure of a pension’s liability “has been used ...primarily to justify reducing employers’ contributions.The reduction in contributions had been or was expected to be temporary; the rates would be increased again in the future. ...All that had occurred was a deferral of costs to the future and a disruption of an orderly funding process.”
- “As a result, legislatures have been pressured to reduce employer contributions or increase benefits without increasing contributions, and some of those efforts have been successful.”

This is further evidence that accounting disclosures can and do make an impact on the actual funding of pensions. Similar points were presented in comments concerning the PV, but no material changes were made in the ED. It appears the divorce is a certainty.

Required Effort to Comply

All plans and employers will require additional effort in pension reporting in their financial statements due to the increased amount of information required to be disclosed. This additional disclosure includes detailed information concerning changes in the net pension liability, the reconciliation of the deferred recognition accounts (called the *deferred outflow and inflow of resources*), information on the basis used for development of the plan's long-term investment return assumption and the selection of the municipal bond index where applicable, as well as descriptions of significant actuarial assumptions and plan benefits.

Under the ED for Amended Statement No. 25, there will be an additional effort needed to provide the required measures and disclosure information. Much of this effort is due to the requirement that the benefit payments and expected contributions be projected to determine if the fund balance will be exhausted. If the assets are expected to be depleted, the actuary must then determine a blended discount rate. The blended rate is the single rate that generates an equivalent present value of benefit payments to that determined by using the plan's assumed long-term investment rate of return to discount expected benefit payments until the assets are depleted, and using an index rate for high-quality, tax-exempt, 30-year municipal bonds to discount the remaining projected benefit payments. The resulting blended rate is used in determining the total pension liability of the plan instead of the plan's assumed long-term rate of return. Additionally, for disclosure purposes the actuary is required to calculate the net pension liability using discount rates one percent greater and one percent less than the rate used in determining the plan's net pension liability.

Under the ED for Amended Statement No. 27, there will be an additional effort required by the plan's actuary in the determination of the pension expense. This requirement is that the changes to the net pension liability due to changes in assumptions and annual non-investment-related gain and loss experience attributable to active members be recognized over the "liability weighted" average working lifetime of those members. This measure is not a result typically produced in the course of preparing an actuarial valuation. As we understand the requirements, additional calculations for each individual active member will be necessary.

In the case of cost-sharing multiple employer plans (e.g., a typical statewide teachers' retirement system), the additional effort will be very significant. In addition to the extra effort described above, the ED calls for the allocation of the net pension liability and pension expense to each participating employer.

Much remains unclear on the specifics of what GASB desires for an allocation methodology but based upon our understanding of the EDs, the task requires calculations on an individual employer basis that are not typically performed in actuarial valuations. Below we discuss points where the technical details for applying the ED are not well defined or will result in significant additional effort by the actuary.

Some Specific Actuarial Issues

As noted above, the Amended Statement No. 27 ED (Paragraphs 28 and 59) calls for amortizing gains and losses differently for active and inactive members. Clarification will be needed for cases where a member changes between these statuses during the year. Further the paragraphs state that the period should be reflective of the members for whom the change is associated. This may suggest that gains or losses from retirement rates differing from the assumed rates should be spread over the actives eligible for retirement while the withdrawal experience is spread across actives not eligible for retirement and salary gain/loss is spread across all actives. Presumably this level of complexity was not intended, but the open-ended description involved doesn't rule it out.

Effects on Cost-sharing Plans

For cost-sharing plans, the Amended Statement No. 27 ED calls for allocating various measurements to an individual employer in proportion to the projected long-term contribution effort (Paragraph 46). It should be noted that "long-term" is not defined, leading to several possible approaches.

One approach would be to only consider current active members, but this does not seem to be consistent with the guidance in paragraph 250, which states in part: "it (the Board) notes that the process of projecting long-term contribution efforts at the collective level is required to determine the discount rate and that those projections might be a starting point for determining the allocation of the collective net pension liability to participating employers." That would suggest a period of time longer than current active members' working lifetimes.

Another approach would be to project the long-term contribution effort to some predetermined number of years such as 25, 50, 75, or 100. Of course, we would expect different results at each of these, particularly if a new tier has been introduced in a system that has groups with different demographic patterns (e.g. school districts and local government entities in the same statewide system). Further guidance will be needed.

Related to this allocation is the observation that many large systems include some very small employers. For instance, a statewide system could have well over 100,000 members, including a library district with two employees who work part time. To try to avoid significant changes year to year due to rounding, the ratios calculated would have to be rounded to the nearest 1 - 10,000th or 1 - 100,000th of 1% — a numerical precision not normally attempted in actuarial valuation calculations.

GASB appears to strive for a level of precision in the allocation of the net pension liability for cost-sharing employers without concern that the resulting allocation is inherently incorrect. The primary reason that such a calculation is incorrect is that cost-sharing plans pool their assets and, since the net pension liability is the total pension liability net of the plan's assets, there is no completely accurate manner to allocate this net liability to each participating employer without the accurate allocation of the plan's assets.

Further, the premise of a cost-sharing plan is to determine the entire plan's required funding, which is equally shared by all participating employers. This is typically accomplished by requiring all employers to fund the plan at the same percentage of covered payroll. In doing so, the contribution requirement of the cost-sharing plan is very likely to be either higher or lower than the rate a particular employer would otherwise need if they had established a single employer plan. In requiring the net pension liability and pension expense to be allocated to each employer in a manner that could have a significantly different value of liability and expense than a stand-alone plan, it may result in many employers reconsidering their participation in the cost-sharing plan based upon a perception derived from inherently incorrect calculations intended for financial reporting alone.

If this results in the migration of participating employers who perceive they could fund the same pension benefits under a single employer plan at a contribution rate less than the cost-sharing rate, the longer-term outcome may be a cost-sharing plan that would have an increased contribution rate required of the remaining employers.

Additionally, each of the migrated single-employer plans would face the increased demographic risks of a smaller experience pool, the higher administrative expenses of maintaining a smaller plan, the higher investment related expenses associated with a smaller amount of assets, and lower long-term investment returns due to less diverse asset allocations. In short, this is a lose-lose outcome.

Our Recommendations

If the allocation process is to remain as outlined in the EDs, we recommend using the covered payroll of participating employers as a cost-effective way to allocate a fundamentally imprecise net pension liability and expense for cost-sharing employers. This simple approach would avoid much unnecessary effort and expense in complying with the GASB requirements. However none of the methods under consideration would cover a participating employer with only inactive members. This possibility underscores the arbitrary allocation sought by the EDs.

We also recommend the use of the plan's average working lifetime calculation (without liability weighting) in spreading the recognition of the change in pension liability due to experience gains and losses as well as assumption changes attributable to active members. The plan's average working lifetime is a calculation that is typically produced in a plan's actuarial valuation and will reduce the level of effort and expense required by the current exposure drafts.

In addition, our preference is to avoid the complete divorce of accounting and funding. However, if it is the unwavering desire of GASB for this to occur, we are compelled to argue for changes to the current EDs to reduce both the possibility of misperceptions as well as the additional expense to plans and employers for complying with the amended statements. We believe that it will be incumbent upon everyone who understands that funding and accounting will now be separate to use every opportunity to make the distinction known to others.

Conclusion

By repeatedly stating their belief that accounting should not impact funding, we are concerned that GASB's EDs are too narrowly focused on the concepts of accounting and do not consider the likely reaction of employers and other decision makers who may not see so clearly that the purpose of such significant accounting changes on financial statements has nothing to do with the funding of the plan.