GAAFR REVIEW

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Report from GASB

In March, the Governmental Accounting Standards Board (GASB) met once in a regular meeting and once by teleconference to pursue work on several of its technical agenda projects.

Postemployment benefits

The board approved for release a staff Invitation to Comment (ITC) document on *Pension Accounting and Financial Reporting*. The new ITC is the subject of a separate "Recent Releases" article in this issue of *GAAFR Review*.

Public/private partnerships

The board considered, but finally rejected, the inclusion of service and management arrangements (SMAs) within the scope of the project. Rather, the scope of the project will be limited to service concession arrangements (SCAs).

The board then addressed issues specifically related to SCAs. The first such issue was how a transferor should recognize revenue from upfront payments, annual installments, or predetermined sums. The board agreed that the proposed standard should refrain from mentioning any specific method(s) of revenue recognition, and call instead simply for the use of some "systematic and rational method."

The board then considered how to measure the intangible asset that results when an operator constructs the asset in return for the right to collect user fees. The board concluded that cost, not fair value, was the appropriate measure. The board also agreed, once again, to refrain from identifying one or more specific amortization methods.

The board also determined that there already is authoritative guidance on how to account for arrangements in which the transferor makes payments to the operator for construction or improvement of the facility and for subsequent operation. Accordingly, the basis for conclusions in the final standard will simply refer to that guidance.

Financial instruments omnibus

The board decided at its March meeting that the proposed interpretation should do all of the following:

- Incorporate guidance now found in the *Comprehensive Implementation Guide* on how to identify 2a-7-like external investment pools;
- Direct that external investment pools that do *not* qualify for the 2a7-like exception be measured at fair value;
- Amend authoritative standards for pension and OPEB plans to state that unallocated insurance contracts are measured at fair value;
- Amend the standard for investment disclosure to limit interest rate risk disclosures to bond mutual funds;
- Exclude non-exchange-traded revenue-based contracts from the scope of the standard on derivatives;
- Exclude both fixed and variable penalties for nonperformance from the net settlement characteristic established for derivatives; and
- Indicate in the authoritative guidance on derivatives that leveraged yield could be present if the initial rate of return on the companion instrument has the potential to double the yield.

Conversely, the board concluded that the *Comprehensive Implementation Guide* would be a more appropriate means of providing guidance on deposit placement services for FDIC-insured deposits. The board also agreed that the optional disclosures for realized gains and losses would be more appropriately addressed in the fair value measurements project. The board plans to conduct research on whether to drop the exclusion of financial guarantees from the scope of its authoritative guidance on derivatives.

Recognition and measurement attributes

The board reached two conclusions on the measurement attributes for assets:

- If an asset is used to provide services, it should be measured at its initial value (i.e., cost) and

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Recent Releases

GASB REVISITS PENSION ACCOUNTING

At the end of March 2009, the Governmental Accounting Standards Board (GASB) issued an Invitation to Comment (ITC) document that solicits the views of interested parties on certain key aspects of *Pension Accounting and Financial Reporting* for state and local governments. The GASB has asked respondents to provide their comments by no later than July 31. A public hearing on the ITC has been scheduled to take place at the GASB's offices in Norwalk, Connecticut, on August 26, 2009.

Background of ITC

The current authoritative guidance on pension accounting and financial reporting for state and local governments is contained in two GASB standards issued in 1994:

- GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*
- GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*

GASB Statement No. 25 became effective for periods beginning after June 15, 1996, while GASB Statement No. 27 took effect for periods beginning after June 15, 1997.

During its later project on accounting and financial reporting for other postemployment benefits (OPEB), the GASB concluded that there was no real difference in economic substance between pension benefits and OPEB. Accordingly, GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* is closely modeled on GASB Statement No. 25, and GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* closely parallels GASB Statement No. 27.

The GASB periodically reviews all of its standards still in force to satisfy itself that the guidance they contain continues to meet the needs of financial statement users. Thus, starting in April 2008, the GASB undertook a reconsideration of its current guidance on postemployment benefits (i.e., pension and OPEB), starting with a comprehensive review of GASB Statements No. 25 and No. 27. The March 2009 ITC is the first due-process document to result from that review. Because of the essential similarity between pensions and OPEB just mentioned, the ITC indicates that changes in the one likely would ultimately lead to corresponding changes in the other.

Since the release of GASB Statements No. 25 and No. 27 in 1994, the board has issued both GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, and GASB Concepts Statement No. 4, *Elements of Financial Statements*. The ITC encourages respondents to take both documents into account in preparing their responses.

The scope of the ITC is limited to financial statements prepared using the economic resources measurement focus and the accrual basis of accounting (i.e., government-wide financial statements, proprietary fund financial statements, and fiduciary fund financial statements). The ITC does *not* address financial reporting for governmental funds, which use the current financial resources measurement focus and the modified accrual basis of accounting.

Employers in single-employer and agent multiple-employer plans

The ITC contains seven chapters. The first five focus on issues related to employers that offer pension benefits through a single-employer plan or an agent multiple-employer plan.

Focus of accounting and financial reporting

Pension benefits, like OPEB, are a form of employee compensation. Therefore, an employer incurs an obligation to employees for pension benefits as employees provide the service being thus compensated.

How an employer incurs a pension obligation is one thing; how an employer finances that obligation can be quite another. On the one hand, changes in an employer's pension obligation can vary considerably from one period to the next, for a variety of reasons (e.g., a change in the benefit formula that will apply to years of service *prior* to the change, differences between actuarial assumptions and actual results). On the other hand, for budgeting purposes, a financing approach that produces an annual pension contribution that will remain relatively stable over time as a percent of payroll is clearly desirable.

The ITC asks respondents whether financial reporting should provide information on how the employer is *incurring* the obligation for pension benefits (i.e., focus on obligation), information on how the employer is *financing* those benefits (i.e., focus on funding), or both types of information. Today, private-sector pension standards tend toward the former approach, while GASB standards lean the other way.

Liability recognition

Not every *obligation* constitutes a *liability* that need to be displayed on the face of the statement of net assets. Thus, public-sector employers, for example, traditionally have *not* reported an accounting *liability* for their unfunded accrued benefit obligation to employees for benefits already earned. Instead, employers have reported an accounting liability only for the cumulative effect of any failure on their part to fully fund annual required pension contributions in the current and prior periods. Conversely, the unfunded benefit obligation of private-sector employers is reported on the face of the financial statements.

The ITC invites respondents to take a position on which approach provides a better measure of the employer's *liability* for pension benefits, based on the authoritative definition of that term offered in GASB Concepts Statement No. 4, paragraph 17:

> *Liabilities* are present obligations to sacrifice resources that the government has little or no discretion to avoid.

Expense recognition

Under the economic resources measurement focus and the accrual basis of accounting, the effect of events and transactions normally is recognized when they occur. Certain aspects of employer accounting for pensions, however, depart from this general rule.

Assume that an employee has already completed fifteen years of service and is expected to provide yet ten more years of service prior to retirement (i.e., 15 years completed + 10 remaining = 25 years in total). Further assume that the benefit formula (e.g., 2 percent of final salary x number of years of service) is adjusted in the current period in the employee's favor (e.g., from 2 percent to 3 percent) and that the new formula will apply to all 25 years of service (i.e., a *retroactive benefit enhancement*). Under current GASB standards, the increase in the employer's unfunded accrued benefit obligation resulting from the change could be amortized as expense by the employer over a period of up to 30 years (even though the employee was expected to provide only ten more years of service).

The same option is available for actuarial gains and losses (i.e., differences between the assumptions used by the actuaries to perform their calculations and the later actual amounts). Once again, under current GASB standards, the effect on employer pension cost could be amortized for up to 30 years.

GASB Concepts Statement No. 1, *Objectives of Financial Reporting*, paragraph 61, enunciates the principle of *interperiod equity*, as follows:

> financial reporting should help users assess whether current-year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided

The ITC invites respondents to indicate whether they believe the deferral and amortization of pension-related costs is consistent with this principle.

Measurement

The pension formula normally will be applied to some *future* salary level (e.g., salary upon retirement). That future salary level typically will be affected by intervening events (e.g., future promotions and inflation-related salary adjustments). Under current GASB standards, the calculation of the accrued benefit obligation of the employer should take into account the anticipated effect of such events (e.g., cost-of-living adjustments and projected salary increases). The ITC invites respondents to consider whether such *future* events should affect the calculation of *today's* accrued benefit obligation for employers.

Furthermore, the calculation of an employer's accrued benefit obligation is reduced by anticipated earnings on amounts placed in trust. Under current GASB standards, the rate of return assumed for this purpose (i.e., *discount rate*) is based on the pension plan's estimated long-term investment yield. Critics of current practice have argued for various alternatives that would tend to produce a lower discount rate and, consequently, a higher unfunded accrued benefit obligation (e.g., risk-free rate of return, employer's borrowing rate, average return on high-quality municipal bonds). The ITC invites respondents to provide their views on what discount rate should be used.

Application of amortization

The effect of certain events and transactions on pension benefits, as explained earlier, sometimes may be deferred and amortized over future periods under existing GASB standards. As already noted, the ITC invites respondents to voice their opinion on the appropriateness of the deferral and amortization approach in general. The ITC goes on to ask respondents to address a number of specific issues related to amortization that need to be considered if the recognition of certain items continues to be deferred and amortized.

Selection of actuarial methodology. Current GASB pension standards allow for the use of any one of six different actuarial cost allocation methods for financial reporting purposes (i.e., entry age, frozen entry age, attained age, frozen attained age, projected unit credit, or aggregate), which is consistent with an emphasis on how employers *finance* their pension obligation. The private sector, on the other hand, mandates the use of a single actuarial method (i.e., projected unit credit), consistent with a focus on how employers *incur* their pension obligation. The ITC asks respondents for their views on which method(s) should be used and why.

Amortization period. As noted earlier, deferral and amortization may occur over a period as long as 30 years. In the private sector, amortization is limited to a much shorter period (i.e., remaining service life of employees). The ITC asks respondents whether the maximum permitted amortization period should be different for different items (e.g., retroactive benefit enhancements v. actuarial gains and losses), and what the maximum period(s) should be.

Amortization method. Under current GASB standards, deferred items may be amortized either as a level dollar amount or as a level percentage of payroll (the former method being more aggressive). Likewise, current standards permit amortization to occur over either a fixed period (*closed* amortization) or a rolling period (*open* amortization). The ITC invites respondents to express their views on both options.

Asset valuation. Assets are reported on the face of financial statements as of a point in time (i.e., the last day of the reporting period). For investments reported at fair value (as are most investments of pension plans), fair value as of the last day of the reporting period is not necessarily indicative of fair value over time, or of fair value at any other point in time. Accordingly, current GASB standards allow actuaries to use an averaged measure of fair value rather than a point-in-time measure for purposes of calculating the employer's unfunded accrued benefit obligation. The ITC solicits respondents' views on the appropriate measure of the value of investments for this purpose.

Employers (cost-sharing plans)

The sixth chapter of the ITC focuses on the issue of the proper accounting and financial reporting for employers that participate in cost-sharing multiple-employer pension plans.

Background on cost-sharing plans

In a single-employer pension plan, there is no one other than the employer to make up for a deficiency should pension plan resources prove inadequate to provide timely benefit payments to retirees, thus exposing the employer to a certain degree of ongoing risk. Consequently, current authoritative standards require that employers in single-employer plans recognize an *accounting* liability (i.e., *net pension obligation*) for their cumulative failure to fully fund annual required contributions (ARC) calculated using actuarial parameters established by the GASB and consistent with accepted actuarial practice.

In an agent multiple-employer pension plan, the actuary calculates a separate rate for each participating employer based on that employer's specific experience and circumstances. Thus, different participating employers in the same plan will have different rates. Viewed another way, an agent multiple-employer pension plan is really an aggregation of single-employer plans whose management has been "outsourced" to a centralized administrative entity. For that reason, the ongoing risk inherent to an employer in a single-employer plan is just as applicable to an employer that participates in an agent multiple-employer plan. Accordingly, employer accounting for single employer plans and agent multiple-employer plans is virtually identical.

Cost-sharing multiple-employer pension plans, however, function quite differently. Rates are set for employers based on the combined experience and circumstances of *all* participating employers, meaning that participating employers share the same rates. Furthermore, if plan resources were to prove inadequate to pay benefits in a timely fashion, it would be the plan in the aggregate, rather than any individual participating employer, that would need to make up the difference. Therefore, under current GASB standards, employers participating in a cost-sharing pension plan are never required to report expense beyond their contractually mandated contributions, *with no requirement that the employers' contributions be calculated within specified actuarial parameters.*

Employers in cost-sharing plans

As just described, current pension accounting for employers in cost-sharing plans is much like insurance accounting. That is, the accounting and financial reporting presumes that the ongoing risk of insufficient plan resources to make timely benefit payments has effectively been transferred to the plan, regardless of how employer contributions have been calculated.

The ITC invites respondents to indicate whether they find the current treatment satisfactory, believe additional information is needed, or believe that employers who participate in cost-sharing plans should use the same accounting and financial reporting as those who sponsor single-employer plans or participate in agent multiple-employer plans.

Plan reporting issues

The last chapter of the ITC solicits the views of respondents on two issues specifically connected with financial reporting by pension plans (rather than employers).

Liability recognition

The purpose of a pension plan, of course, is to accumulate sufficient *resources* to ensure the timely payment of *promised benefits* as they become due to retirees. Users of pension plan financial statements often seem to expect to find both on the statement of plan net assets (i.e., an asset for accumulated resources and a liability for the obligation to pay future benefits). Under existing standards, however, the liability recognized for benefits is limited to amounts actually due and payable. That is, the overall accrued benefit obligation of the plan does *not* constitute an *accounting* liability. The ITC invites respondents, in the light of the definition of a *liability* quoted earlier, to take a position on the appropriate measure of the plan's *liability* for benefits (i.e., accrued benefit obligation v. benefits due and payable).

Changes in the unfunded obligation

The unfunded accrued benefit obligation (i.e., the excess of the accrued benefit obligation over plan assets accumulated to pay benefits) has long been a key focus of interest in discussions of the financial health of pension plans. Under current GASB standards, neither employers nor pension plans are required to present *changes* in that amount.

The ITC first invites respondents to indicate whether the presentation of changes in the unfunded accrued benefit obligation should be presented. If so, the ITC asks whether those changes should be presented by the employer, the plan, or both.

Should the presentation of changes in the unfunded accrued benefit obligation ultimately be required, which of the three communications methods set forth in GASB Concepts Statement No. 3 should be used?

- Display (i.e., presentation as a basic financial statement);
- Disclosure (i.e., notes to the financial statements); and
- Supporting information (i. e., required supplementary information and supplementary information). SJG

New GASB Statements

INCORPORATION OF AICPA GUIDANCE

In March 2009 the Governmental Accounting Standards Board (GASB) issued both GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments* and GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*. Neither statement represents a change in current practice and both took effect immediately upon issuance.

Background

The American Institute of Certified Public Accountants (AICPA) issues Statements on Auditing Standards (SAS), Audit and Accounting Guides (e.g., *State and Local Governments*), and Statements of Position (SOP), to provide authoritative guidance on generally accepted auditing standards. In times past, it was not uncommon for such publications to offer guidance on specific accounting and financial reporting treatments not otherwise available in the authoritative accounting and financial reporting technical literature. In more recent years, a consensus has emerged in favor of codifying generally accepted accounting principles (GAAP) to minimize the need to consult multiple sources. With that consensus in mind, representatives of the AICPA approached both the GASB and its private-sector counterpart, the Financial Accounting Standards Board (FASB), to request that both bodies undertake projects to incorporate all relevant AICPA guidance on accounting and financial reporting topics into the authoritative GASB and FASB technical standards. The GASB formally added the topic to its research agenda in late 2007. After the completion of its initial research, the board then added the topic to its active technical agenda in April 2008. In August of that same year, the board issued two exposure drafts (EDs) to solicit the views of interested parties.

The GAAP hierarchy

In January 1992, the AICPA issued SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, which established a "hierarchy" of sources of GAAP. GASB Statement No. 55 does not alter the guidance in SAS No. 69, but rather relocates it within the GASB's own technical literature. The FASB accomplished this same goal in May 2008 by means of FASB Statement No. 162, *The Hierarchy of Generally Accepted Accounting Principles*.

It may be worthy of note that the description of *other accounting literature* provided in paragraph 6 of GASB Statement No. 55 has been expanded to encompass the various standards of the Federal Accounting Standards Advisory Board, the International Public Sector Accounting Standards Board, and the International Accounting Standards Board.

Related party transactions

Auditing Standards (AU) Section 334 provides guidance on *related party transactions*. That guidance has now been incorporated in GASB Statement No. 56.

The key notion underlying this related party guidance is the need for accounting and financial reporting to emphasize economic substance over form. As a rule, the "substance" of a related party transaction is what that same transaction would have looked like had it been an arm's-length transaction. The traditional guidance, of course, always emphasized that

> It may not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or what the terms and conditions would have been. Therefore, it may be difficult to determine whether a transaction was consummated on terms comparable to those that would be present in arm's-length transactions. (paragraph 7).

The GASB has expanded this discussion in GASB Statement No. 56 to underscore the need for special care in the application of this guidance to the public sector:

> Governments frequently enter into transactions and engage in activities that are driven by societal needs and concern for the "public good." Therefore, it may not be appropriate to compare some governmental programs and arrangements to what might have occurred in an arm's-length transaction in the private sector or with unrelated parties.

Subsequent events

AU Section 334 provides guidance on *subsequent events*. That guidance traditionally has distinguished between *type one events* (i..e., items that require an adjustment to amounts reported in the financial statements) and *type two events* (i.e., items that require disclosure, but do not affect the amounts reported in the financial statements). The FASB's October 2008 ED on *Subsequent Events* proposed to adopt the AICPA guidance without substantive change, but to replace the traditional terminology with more descriptive terms. Thus, a type one event would henceforth be referred to as a *recognized event*, while a type two event would be known in the future as a *nonrecognized event*. The GASB has followed this same approach in GASB Statement No. 56.

Going concern considerations

AU Section 341 provides guidance on *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. Once again, GASB Statement No. 56 adopts the AICPA guidance without substantive change. It does, however, explain that some of the conditions and situations traditionally seen as potential indicators that the going concern assumption may be in jeopardy "should be assessed differently for governments." GASB Statement No. 56 also clarifies that going concern considerations should be applied only to legally separate entities (e.g., the primary government and component units), and *not* to lesser units (e.g., individual funds) SJG

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Report from GASB *(continued from front page)*

- If an asset is *not* used to provide services, it *normally* should be reported at a remeasured value (e.g., fair value).

Service efforts and accomplishments reporting

Starting at its April meeting, the board plans to review a draft due-process document on *Proposed Suggested Guidelines for Voluntary Reporting of SEA Performance*, that will follow up on its earlier request for response document on the same topic.

AICPA omnibus projects

The GASB issued two new standards (Statements Nos. 55 and 56) that will incorporate into the GASB technical literature certain guidance now found only in the auditing literature of the American Institute of Certified Public Accountants (AICPA). Those new standards are the subject of a separate article in this issue of *GAAFR Review*.

Chapter 9 bankruptcies

The board tentatively decided that the proposed guidance should include a provision for recognizing a reduction of liabilities as of the date a plan of adjustment is confirmed by the court, or as of a later date when all material conditions precedent to the plan's becoming binding are resolved. The board also agreed that the proposed measurement approach should measure the liability at "the total future cash payments specified by the new terms," if those payments are less than the carrying amount of the liability. Likewise, an appropriate discount rate, consistent with Accounting Principles Board Opinion No. 21, *Interest on Receivables and Payables*, would need to be applied to those future cash payments.

The board plans to propose that all gains resulting from debt restructuring in Chapter 9 bankruptcies be classified as an extraordinary gain. However, legal and other direct costs associated with bankruptcy would *not* be part of this calculation. For entities that are not expected to emerge from Chapter 9 Bankruptcy, the board concluded that the entity's assets should be reported at a remeasured value that represents the amount expected to be received. JWL

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