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Invitation to Comment: Plain-Language Supplement

Pension Accounting and Financial Reporting

This plain-language supplement to an
Invitation to Comment is issued for public comment.

Written comments should be addressed to:

Director of Research and Technical Activities
Project No. 34

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Governmental Accounting Standards Board
of the Financial Accounting Foundation

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This document is a plain-language supplement to an Invitation to Comment, *Pension Accounting and Financial Reporting*, issued by the Governmental Accounting Standards Board. This supplement is prepared for citizens, taxpayers, elected representatives, municipal analysts, and other external users of governmental financial information and uses a minimum of technical terminology. The supplement references the Invitation to Comment and should be read in conjunction with it. The Invitation to Comment can be downloaded from the same location as this supplement: www.gasb.org/exp/. Questions for *users* of governmental financial information are posed throughout this supplement. Instructions for responding to the questions may be found on pages 17 and 18. Preparers and auditors of financial statements and actuaries are requested to answer the questions posed in the Invitation to Comment.

OVERVIEW

The primary goal of the Governmental Accounting Standards Board (GASB) is to develop effective standards of accounting and financial reporting for state and local governments. Effective standards lead to information in financial reports that improves transparency, supports accountability, and is useful for making important decisions. To ensure that standards continue to achieve these objectives, the GASB periodically reviews its existing standards.

The GASB's standards for accounting for and reporting on the pension benefits that governments provide to their employees have been in effect for over a decade. In 2006, the GASB began a research project to examine whether those standards are effective. This supplement accompanies an Invitation to Comment that describes key issues raised during the research project and explores potential approaches to addressing them. The purpose of the Invitation to Comment is to seek public input on the importance of those issues to transparency, accountability, and decision usefulness and the appropriateness of the alternative approaches to pension accounting and financial reporting.

This supplement begins with background information about state and local government pension benefits. The sections that follow correspond with the chapters of the Invitation to Comment. This supplement concludes by posing questions specifically written to ask users of governmental financial information how the issues in the Invitation to Comment would affect the decision usefulness of the information they receive. Users also may answer the questions posed in the Invitation to Comment. Other readers of this supplement, such as those that prepare or audit government financial statements, are requested to answer the questions in the Invitation to Comment rather than the questions in this supplement.

One might expect that this supplement would discuss the applicable GASB standards that governments follow when reporting on their pensions. Rather than examined prominently, the standards are summarized in Appendix A to this supplement. The GASB encourages you to consider the alternative approaches to addressing key issues raised in the Invitation to Comment on their own merits. The potential impacts of changing the way pensions are accounted for and reported at present are relevant and will

be taken into consideration should the GASB explore changes in the future. First, however, the GASB would like to understand what approaches would serve your information needs best.

HOW ARE PENSIONS ADMINISTERED AND FUNDED?

Employees of state and local governments generally receive two types of compensation in return for their labor—current compensation (salaries and health insurance benefits, for the most part) and deferred compensation (primarily pensions and retiree health insurance). Both current and deferred compensation are earned by the employees as they work. But whereas salaries and other forms of current compensation generally are received by employees while they are still employed by the government, deferred compensation is not received until after employees have retired or otherwise left the employment of the government. The most common form of deferred compensation is pension benefits.

What Is the Difference between Defined Benefit and Defined Contribution Pensions?

Pension plans can be divided into two basic forms—defined contribution and defined benefit. *Defined benefit* plans—the most common form in government—are those that specify the *amount of benefits to be provided* to the employees after the end of their employment. Defined benefits generally are financed following an *actuarial* approach, which entails paying to a pension plan each year an amount that is expected to be sufficient, if invested now, to finance the benefits of employees after they are no longer working for the government.

Defined contribution pension plans consist of governments setting aside a specified amount of money on a predetermined schedule in an investment plan (similar to a 401k for a private-sector employee). Defined contribution plans stipulate only the *amounts to be contributed by a government employer* to plan member accounts each year of active employment and do not specify the amount of benefits employees will receive after the end of their employment. The amount that the employees receive when retired depends on how much the invested contributions earn over time. The better the investments perform, the more the retirees will receive.

What Are Sole-Employer and Multiple-Employer Plans?

Plans also may be distinguished by how many employers participate in them. As their name indicates, *sole-employer* plans involve only one government, whereas *multiple-employer* plans include more than one government.

In a *cost-sharing* multiple-employer plan, governments *pool* or *share* the costs of financing benefits and administering the plan and the assets accumulated to pay benefits. Generally, a single actuarial valuation is conducted for all of the employees of the participating governments *combined*.

In *agent* multiple-employer plans, there is no pooling of benefit costs. Separate accounts are maintained to ensure that each employer's contributions are used to provide

benefits only for the employees of that government. Separate actuarial calculations are made for each participating government in the plan. However, to take advantage of economies of scale, the cost of administering the plan is shared by the participating governments, and the plan assets generally are pooled for investment purposes.

How Do Governments Determine How Much to Contribute to a Defined Benefit Plan?

As previously noted, the process of determining how much should be set aside now in order to provide for future benefits in a defined benefit plan normally utilizes actuarial methods and assumptions. An actuary's estimate or *valuation* is the product of many assumptions, based on historical experience, regarding the factors that determine the level of resources that will be needed in the future to finance benefits. These factors may include, but are not limited to:

- How many employees a government is expected to have that will receive benefits
- How long employees are expected to work for the government
- How long employees are expected to live after retiring (and, hence, how many years they will receive benefits)
- How large a return a government is expected to receive on its investments.

The actuary calculates *how much should be contributed now* to provide that adequate resources are available in the future. The future cash outlays for pensions are projected based on economic and demographic assumptions such as those mentioned above. These cash outflows are then discounted to their *actuarial present value*—their estimated value if paid today—using a discount rate equal to an assumed long-term rate of return on investments. Portions of the actuarial present value generally are allocated as costs attributable to past, current, and future years during which employees have worked or are expected to work in exchange for the benefits.

One portion of the actuarial present value can be attributed to prior years for benefits employees *have already earned*. Another portion relates to benefits *expected to be earned* by employees in the future. The portion of the actuarial present value allocated to prior years of employment is called the *actuarial accrued liability (AAL)*.

Pension plans generally have some cash, investments, and other resources accumulated to fund the AAL. The value of these resources is referred to as the *actuarial value of assets*. The actuarial value of assets generally is not the same as their market or fair value in any given year. Annual gains or losses in plan assets generally are averaged over several years (usually three to five) by the actuary, producing a trend in actuarial value that incorporates these changes over time.

The excess of the AAL over the actuarial value of assets is the *unfunded actuarial accrued liability (UAAL or unfunded liability)*. (The Invitation to Comment employs a generic term, *unfunded accrued benefit obligation*.) The unfunded liability is amortized (recognized in increments) over a period of up to 30 years, either in *level dollar* amounts or as a *level percentage of projected payroll*, utilizing one of six acceptable actuarial cost methods. Like a home mortgage, the level dollar method divides the liability into equal dollar amounts over the selected number of years; each payment is part interest, part

principal. The level percentage method calculates payments so that they equal a constant percentage of payroll over time; most governments use this method when reporting their pension benefits.

The portion of the actuarial present value of benefits that is related to benefits newly earned in the current period is called the *normal cost*. The normal cost and the portion of the UAAL to be amortized in the current period together make up the *annual required contribution* (ARC) of the employer for the period. Contributions to a pension plan in the amount of the ARC are expected to provide sufficient resources to fund both the normal cost for each year and the amortized unfunded liability.

WHAT SHOULD BE THE FOCUS OF PENSION REPORTING? (Chapter 2)

Key Issue: Chapter 2 raises the most fundamental question—what transaction or event should governments account for and report in their financial reports?

Chapter 2 offers a choice between two *processes* related to defined benefit pensions:

- “The process by which an employer *incurs an obligation to employees for defined pension benefits earned by them*”—in other words, an employee works for a government and in exchange the government owes the employee compensation, a portion of which comes in the form of pension benefits to be paid when the employee retires
- “The process by which an employer *finances its projected future cash outflows for defined pension benefits*”—in other words, a government that owes pension benefits to its employees sets about determining how to accumulate resources to pay those benefits when they come due in the future.

You are asked in Chapter 2 to decide which of those processes should be the focus of accounting and financial reporting based on the degree to which they meet these objectives of financial reporting by governments:

- *Accountability*—reporting that helps citizens and others to assess their government’s accountability for the efficient and effective use of public resources and assists governments to demonstrate their stewardship over those resources
- *Decision usefulness*—reporting that produces information that is useful for making decisions, such as whether to buy a government’s bonds, where to purchase a home or send a child to school, how to vote on a school budget or municipal bond referendum, or how to allocate scarce resources in a budget.

You also are asked to consider a related objective that bears on pension reporting—*interperiod equity*. Reporting that addresses interperiod equity helps one to assess whether a government is covering the costs of providing services with resources raised during the period in which the services were provided, or if the government is shifting costs to future periods. This could be particularly important for pension benefits, which may be received by retirees and their beneficiaries decades after they were actually earned.

Questions for Users about the Underlying Process

The arguments for and against focusing on either of the two processes are set forth in paragraphs 11–19 of Chapter 2. The chapter also offers reasons for and against focusing on *both* processes. You should review the pros and cons with the intention of answering the following questions:

1. a. *Which process, if it were the focus of accounting and financial reporting for defined benefit pensions, would lead to the most useful information for you—(1) the incurrence of the obligation, (2) the financing of the obligation, or (3) both processes?*
- b. *Why would focusing on that process (or both) lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

PENSION LIABILITIES AND EXPENSES (Chapter 3)

Key Issues: Does a government’s promise to provide pension benefits when its employees retire constitute a liability that can be reported in the financial statements? How and when should the cost of pension benefits be reported?

The GASB now has developed definitions regarding how to identify a liability and an expense and where to report them in the financial report—in the form of Concepts Statements No. 4, *Elements of Financial Statements*, and No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, respectively—that it did not have at the time it developed the present pension standards. In light of the definitions now available, Chapter 3 reconsiders the issues of:

- The nature of the government’s obligation for pension benefits
- Whether the obligation is a liability
- What the basis for recording an expense should be
- Whether the liability, if one exists, and expense should be recognized on the face of the accrual-basis financial statements (which include all but the governmental fund statements), disclosed in the notes to the financial statements, or presented as required supplementary information (RSI).

The chapter lays out three alternative approaches to addressing the issues.

Alternative 1

The first alternative focuses on the *government's approach to making contributions* to the pension plan. Alternative 1 would place limits on the actuarial methods and assumptions that are employed such that the pension expense would be consistent with the ARC as defined by the GASB. The manner in which common transactions and events related to pensions would be reflected under this alternative is summarized in Table 3.1 of the Invitation to Comment.

What is the liability? The accumulated shortfall between what a government actually contributes to the pension plan and the ARC would be *recognized* as a liability. All things being equal, to the extent that employees work and earn pension benefits but the government makes contributions to the pension plan that are less than the ARC, the liability would grow. The unfunded accrued benefit obligation would be *disclosed* in the notes.

What is the expense? Essentially, the expense would be the ARC. As explained above, the ARC comprises the cost of pension benefits newly earned during the year plus a portion of the UAAL, the accumulated obligation for which no assets have been set aside. The effects of changes in benefit terms, such as ad hoc cost-of-living adjustments (COLAs), revisions to underlying assumptions, and the difference between assumptions and actual experience would be taken into account with each new actuarial valuation and reflected in a new ARC. It would remain to be determined which impacts would be recognized immediately and which would be recognized over time.

Alternative 2

The second alternative focuses on the *government's unfunded accrued benefit obligation* for pensions as a result of employee services that the government already has received. The manner in which common transactions and events related to pensions would be reflected under this alternative is summarized in Table 3.2 of the Invitation to Comment.

What is the liability? The unfunded accrued benefit obligation would be recognized in the financial statements as a liability.

What is the expense? All pension transactions and other events that add to or subtract from the unfunded accrued benefit obligation would be recognized when they occur as changes in net assets in the financial statements. Net increases in the obligation—and thus net decreases in net assets—would be reported as expenses.

Alternative 3

The third alternative combines features of Alternatives 1 and 2. The manner in which common transactions and events related to pensions would be reflected under this alternative is summarized in Table 3.3 of the Invitation to Comment.

What is the liability? As in Alternative 2, the unfunded accrued benefit obligation would be recognized in the financial statements as a liability.

What is the expense? The cost of benefits newly earned each year (the normal cost) would be recognized in the financial statements as an expense. The impact on net assets of the other events that add to or subtract from the liability would be either (1) recognized immediately as expenses or (2) recognized gradually over time as expenses attributable to work to be performed in periods going forward. It would remain to be determined which impacts would be treated in the former method and which in the latter.

Questions for Users about Pension Liabilities and Expenses

The pros and cons of Alternatives 1, 2, and 3 are set forth in paragraphs 18 and 19, 22 and 23, and 27 and 28 of Chapter 3, respectively. You should consider these arguments with the intention of answering the following questions:

2. a. *Which alternative would lead to the most useful information for you—1, 2, or 3?*
- b. *Why would that alternative lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

MEASURING THE UNFUNDED ACCRUED BENEFIT OBLIGATION (Chapter 4)

Key Issues: *How should the potential impact of future changes in benefits be incorporated into actuarial calculations? How should the discount rate be determined?*

This supplement begins with a description of the current process by which governments, through actuarial valuations, determine how much needs to be set aside to provide for pension benefit payments when employees retire. Future benefit payments are projected based on a variety of assumptions and then discounted to their present value. Chapter 4 of the Invitation to Comment considers from a financial reporting standpoint issues about this procedure that were raised during the GASB's research into the experience with its pension standards.

The Effects of Future Changes

Chapter 4 specifically considers whether or not the following changes that occur in the future should be incorporated into the *measurement* (determination of the amount) of the unfunded accrued benefit obligation:

- Automatic cost-of-living adjustments (COLAs)—these COLAs are built into the terms of the pension benefits to counteract the declining purchasing power of the benefit payments
- Ad hoc COLAs—adjustments made periodically that are not anticipated in the benefit terms
- Projected service credits—the assumptions made about how long employees will work
- Salary increases—the assumptions made about how much salaries will grow over an employee’s period of employment.

Projected Service Credits and Salary Increases

Pension benefit payments commonly are calculated by multiplying an assumed final salary (or average salary over the final several years of employment) by a percentage based on the number of years worked. For instance, for an employee that worked 25 years and earned 2 percent of final salary per year, the pension benefit payments would equal the final salary multiplied by 0.50 (25×0.02). The assumptions about how long employees will work also determine how many employees will be assumed to become eligible to receive benefits.

Views regarding whether assumptions about length of service and salary increases should be incorporated into benefit projections tend to vary depending upon which process one believes should be the focus of accounting and financial reporting (refer to Chapter 2). On the one hand, those favoring a focus on how governments fund their pension obligations generally would support including the assumptions (paragraphs 9 and 10 of Chapter 4).

On the other hand, those favoring a focus on the incurring of the obligation agree that projected service should be used to determine *eligibility*, but not to project future benefit payments. (See paragraphs 11–17.) However, while some of them also oppose projecting future benefit payments based on assumptions about salary increases, others would support doing so if it is reasonable to conclude that there is an implied contract that provides for the increases.

Automatic and Ad Hoc COLAs

The chapter also raises an issue about whether a distinction should be made between automatic and ad hoc COLAs. (See paragraphs 3–7 of Chapter 4.) Automatic COLAs are part of the agreed upon compensation and generally their amount and timing are known in advance. By contrast, ad hoc COLAs typically are discretionary, and their amount and timing often are not known at the time employees are working for a government and earning pension benefits. (However, if ad hoc COLAs do occur routinely and in amounts that can be anticipated, then they could be viewed as being substantively similar to automatic COLAs.) The issue raised is whether or not the differences between the two types of adjustments suggest treating them differently in terms of reflecting them in the projection of benefit payments.

Questions for Users about the Effects of Future Changes

3. a. *Which alternative would lead to the most useful information for you—(1) including both projected service credits and salary increases when projecting benefits; (2) using projected service credits to project eligibility, but excluding projected service credits and salary increases when projecting benefits; or (3) using projected service credits to project eligibility, using projected salary increases when projecting benefits if the increases are part of an implied contract, but excluding projected service credits when projecting benefits?*
- b. *Why would that alternative lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*
4. a. *Which alternative would lead to the most useful information for you—(1) excluding all ad hoc COLAs from projections of benefits or (2) including ad hoc COLAs if their amounts and timing are reasonably predictable?*
- b. *Why would that alternative lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

The Discount Rate

At present, the discount rate used to convert the projected future benefit payments into their present value is based on an assumed long-term rate of return on the assets that have been set aside to fund the benefit payments. This assumed rate is based on the specific types and mix of investments held by the pension fund and their inherent risks. To varying degrees, investments carry some risk; in general, the less risky an investment is perceived to be, the lower the reward in the form of the rate of return. Governments that base their discount rate on an expected long-term rate of return face an additional risk that the investments will not perform as well as assumed (actuarial risk).

At least three alternatives to this practice have been suggested:

- *Risk-free rate of return*—this rate is based on the return from securities of the U.S. federal government, which are presumed to be free of the risk of nonpayment
- *Government's borrowing rate*—this rate is not based on a pension plan's investments and, therefore, is not subject to investment or actuarial risk; it is affected, however, by the risk that the government's credit worthiness could change, which in turn would alter the rate it pays when borrowing (credit risk)
- *Average return on high-quality municipal bonds*—this rate is affected by the credit risk attributed to high-quality municipal bonds as a group.

A key consequence of the choice of discount rate is the impact it has on the magnitude of the calculated obligation and, therefore, the amount that would have to be contributed each year to fund the obligation. All things being equal, a lower discount rate

produces a larger present value of the obligation and thus a larger ARC. Generally, each of these alternative discount rates would be considerably lower than a long-term rate of return and, therefore, would produce a larger present value of the obligation and ARC.

Consider, for instance, a stream of annual payments of \$1,000,000 over 30 years. Discounted using the risk-free rate (approximately 3.5 percent for 30-year U.S. Treasury bonds in late February 2009), the present value would be a little less than \$18.4 million. Using an average return on high-quality municipal bonds (approximately 4.9 percent for a AAA-rated 30-year bond) as the discount rate, the present value of the payments would be about \$15.6 million. However, if the discount rate were 8.0 percent,¹ then the present value would be under \$11.3 million—roughly 61 percent of the present value using the risk-free rate.

Questions for Users about the Discount Rate

The pros and cons of using the four discount rates described above are set forth in paragraphs 20–26 of Chapter 4. You should consider these arguments with the intention of answering the following questions:

5. a. *Which discount rate would lead to the most useful information for you—(1) long-term rate of return on pension plan assets, (2) risk-free rate, (3) a government’s borrowing rate, or (4) average rate on high-quality municipal bonds?*
- b. *Why would that discount rate lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

THE USE OF ACTUARIAL METHODS (Chapter 5)

Key Issue: *Which actuarial methods should be allowed for the purpose of deferring the recognition of certain pension costs to future years?*

Chapter 5 examines issues that have been raised about the use of actuarial methods in pension measurement approaches (like the one described at the beginning of this supplement) that involve recognizing some portions of pension costs as expenses over future years (amortization). For the purposes of considering these issues, you are asked to put aside for the moment the Chapter 3 debate over whether amortization should be included in the calculation for financial reporting purposes.

Actuarial Cost Methods

The existing pension standards allow a choice among six acceptable actuarial cost methods. The cost methods determine how total pension cost is allocated over the years. The way in which costs are divided among prior, current, and future years has an effect on

¹GASB research found that, from 1996 to 2005, the median long-term rate of return on investments assumed by large pension plans was 8.0 percent; the median assumed rate for small plans was 7.5 percent.

the size of the pension expense reported in any given year and the degree to which the pension obligation appears to be funded.

One issue related to actuarial cost methods is *how many options* there should be. On the one hand, some people favor the flexibility inherent in having relatively more methods to choose from and the fact that this flexibility supports consistency between how funding decisions are made and the accounting and financial reporting of pensions. On the other hand, some people would prefer fewer options in order to increase consistency across governments and improve the comparability of the resulting information.

If the number of acceptable cost methods were reduced, the issue of *which ones to allow* arises. Particular objections have been raised about three methods—aggregate, frozen entry age, and frozen attained age—that either do not assign the present value of the pension obligation to past periods of service at all (aggregate) or do not assign a significant part of the present value (the two *frozen* methods) to past periods. Some people favor allowing only one or two actuarial cost methods—entry age and projected unit credit. It is notable that the entry age method alone is used by about 8 out of 10 pension plans.

Questions for Users about Actuarial Cost Methods

The pros and cons of which actuarial cost methods should be allowed are set forth in paragraphs 8–18 of Chapter 5. You should consider these arguments with the intention of answering the following questions:

6.
 - a. *Assuming that governments use an approach that involves amortizing some parts of the unfunded accrued benefit obligation, what would lead to the most useful information for you—(1) reducing the number of acceptable actuarial cost methods that governments may choose from, (2) keeping the present six methods, or (3) adding more methods?*
 - b. *Why would your choice lead to the most useful information for you?*
 - c. *In what ways would that information be useful to you? How would you use it?*
7.
 - a. *If you believe that reducing the number of actuarial cost methods would lead to the most useful information for you, which methods would you select?*
 - b. *Why would those particular methods lead to the most useful information for you?*
 - c. *In what ways would that information be useful to you? How would you use it?*

Amortization Methods

The existing standards establish the acceptable methods of amortizing the unfunded accrued benefit obligation and the maximum number of years over which it can be divided. The unfunded obligation can be recognized over as many as 30 years on a *closed* or *open* basis. Closed basis amortization occurs over a set number of years, so that by the

final year the obligation is completely amortized. Open amortization involves either a rolling period that restarts each year or a period that can float or change each year, so long as it does not exceed the maximum of 30 years. As described at the beginning of this supplement, the portions of the obligation are recognized each year either in *level dollar* amounts or as a *level percentage of projected payroll*.

In addition to asking whether it would be preferable for the standards to select either closed or open, and either level dollar or level percentage, Chapter 5 examines three alternatives to the maximum 30-year amortization period:

- Amortization over the average remaining years of service of the employees
- Amortization of different components of pension cost over different periods; for example, the portion of the cost of retroactive benefit increases that relates to past years of work by employees might be recognized immediately or over a brief period
- Immediate recognition of pension costs (in other words, no amortization at all).

Questions for Users about Amortization Methods

The pros and cons of changing the allowable amortization methods and the maximum period are set forth in paragraphs 24–37 of Chapter 5. You should consider these arguments with the intention of answering the following questions:

8. a. *What would lead to the most useful information for you—(1) allowing a choice between open and closed amortization, and between level dollar and level percentage amortization, or (2) specifying one or the other?*
- b. *Why would that lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*
9. a. *What approach to specifying a maximum amortization period would lead to the most useful information for you—(1) up to 30 years, (2) over the average remaining service period for employees, (3) applying different periods to different parts of the pension cost, or (4) immediate recognition of all pension costs?*
- b. *Why would that approach lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

Valuation of Pension Plan Assets

A previous section of this supplement described how governments determine the amounts that need to be contributed to defined benefit pension plans. That section explained that annual changes in the fair value of plan assets generally are not recognized right away but are introduced gradually (usually over three to five years, though the standards do not require a specific period). The resulting amount in any year is the *actuarial value of assets*. The primary rationale for this approach is to minimize the effects on calculations of the ARC of year-to-year volatility that is not expected to be sustained in the long run.

The actuarial value of assets, when compared with the present value of the pension obligation, serves as a basis for determining the ARC and the funded status of a pension plan. (The pension obligation minus the actuarial value of assets equals the unfunded accrued benefit obligation.) Those who favor this approach are concerned that annual volatility otherwise would produce large fluctuations in the ARC from one year to the next; they argue that it would be inadvisable or impractical to make large adjustments to tax levies from year to year in order to fund the ARC.

The crux of the criticism of recognizing changes in asset values over time is that it postpones introducing the year-to-year fair value changes. For some people, avoiding such volatility is not a sufficient justification for what they see as inaccurate measures of funded status in any given year. For example, during a prolonged economic downturn, it might be several years before the decline in funded status is reflected, potentially delaying efforts to rectify the funding situation.

Questions for Users about the Valuation of Pension Plan Assets

The pros and cons of using the actuarial value of assets are set forth in paragraphs 41–44 of Chapter 5. You should consider these arguments with the intention of answering the following questions:

- 10. a.** *What method of determining the value of plan assets would lead to the most useful information for you—(1) allow governments to recognize changes in values over a period of their choosing, (2) allow recognition over a specified period, or (3) require immediate recognition?*
- b.** *Why would that method lead to the most useful information for you?*
- c.** *In what ways would that information be useful to you? How would you use it?*
- 11. a.** *If you believe that answer (2) in Question 10a would lead to the most useful information for you, what do you believe that period should be?*
- b.** *Why would that specific period lead to the most useful information for you?*
- c.** *In what ways would that information be useful to you? How would you use it?*

GOVERNMENTS IN COST-SHARING PLANS (Chapter 6)

Key Issue: Is participation in a cost-sharing plan, as opposed to a sole or agent plan, substantively different enough to justify a different approach to accounting and financial reporting for pensions?

The issues discussed to this point in the Invitation to Comment have related almost entirely to governments participating in sole-employer and agent multiple-employer pension plans. Chapter 6 explores accounting and financial reporting issues relevant to governments in cost-sharing multiple-employer plans—plans that pool the contributions of participating governments.

As described in Appendix A, the accounting and financial reporting requirements for employers participating in cost-sharing plans are different, in part because the actuarial valuation is conducted for the plan as a whole, rather than for the individual participating governments. Consequently, portions of the reporting requirements are ceded from the employer governments to the separately issued financial statements of the plan, most notably the RSI schedules that track funded status over time and compare actual contributions with the ARC.

Another key factor that led to the original development of different requirements is that the pension obligation is shared by the participating governments as a whole and is not attributed in whole or in part to any specific government. A common contribution rate is applied to all participating governments, which are often required by law to make the contribution.

What is less clear is whether the needs of the users of information about cost-sharing plans and their participating employers are substantially different from the needs of users of sole and agent pension plans. For instance, has an employer in a cost-sharing plan, like other government employers, incurred an obligation to provide pension benefits to employees as they have worked? Are the needs of users to understand that obligation any different from the needs of users interested in sole and agent plans?

This chapter questions whether these differences in structure and actuarial activity—and potentially in user needs—between governments in cost-sharing plans, on the one hand, and governments in sole and agent plans, on the other, justify the different accounting and financial reporting requirements they are subject to.

Questions for Users about Cost-Sharing Plans

The pros and cons of the existing requirements for reporting by employers in cost-sharing multiple-employer plans are set forth in paragraphs 6–9 of Chapter 6. You should consider these arguments with the intention of answering the following questions:

12. a. Do the existing accounting and financial reporting requirements for governments participating in cost-sharing multiple-employer plans result in the information you need—yes, no, or partly?

b. If you answered no or partly, what alternative approach to accounting and financial reporting by governments in cost-sharing plans would lead to the most useful information for you—(1) existing requirements, but with additional disclosures by cost-sharing employers (please identify the additional disclosures you would need) or (2) requirements similar to those of sole and agent employers?

c. Why would that approach lead to the most useful information for you?

d. In what ways would that information be useful to you? How would you use it?

REPORTING BY PLANS (Chapter 7)

Key Issues: What liability should be reported by pension plans? Should plans present a statement of changes in the pension obligation?

Chapter 7 examines two issues related to reporting by pension plans in their own, separately issued financial reports. The first issue is what should be reported as a liability in the plan's statement of plan net assets. (See Appendix A for a summary of the existing reporting requirements for defined benefit pension plans.) The second issue is whether additional information should be presented about the changes in the unfunded accrued benefit obligation.

Liabilities of the Plan

The existing accounting and financial reporting requirements for governments and plans are based on key premises that (1) pension benefits are part of an exchange transaction in which a government compensates an employee in return for work performed, (2) the cost of pension benefits earned is a part of the total cost of services each year, and (3) the trustees of the pension plan act in a fiduciary role relative to the financing and administration of pension benefits, but neither the trustees nor the plan are parties to the underlying transaction that established the government's obligation to provide pension benefits to its employees.

Consequently, plan reporting currently focuses on the plan's *stewardship* of the resources entrusted to it, rather than on the exchange that gave rise to the benefits. To the extent that a plan incurs a liability, it is for member benefits that are due but have not yet been paid. The pension obligation of the employer government is not reported as a liability of the plan. The difference between the plan's assets and liabilities is referred to as *plan net assets held in trust for pension benefits*. Likewise, the plan financial statements do not report on the cost of pension benefits but, rather, on the changes in the plan net

assets, such as additions to the plan's assets through contributions and investment income and deductions from plan assets through benefit payments.

Not all people agree with the existing reporting approach. They would like to see the plan financial statements report the accrued benefit obligation as a liability as well, along with changes in the accrued benefit obligation. In so doing, the financial statements would report on the defined pension benefit *arrangement* as a whole.

Questions for Users about Liabilities of the Plan

The arguments about what should be reported as a liability in plan financial statements are set forth in paragraphs 8–11 of Chapter 7. You should consider these arguments with the intention of answering the following questions:

- 13. a.** *What approach would lead to the most useful information for you regarding pension plans—(1) reporting only liabilities arising from member payments due but not yet paid or (2) reporting the accrued benefit obligation as a liability?*
- b.** *Why would that approach lead to the most useful information for you?*
- c.** *In what ways would that information be useful to you? How would you use it?*

Changes in the Unfunded Accrued Benefit Obligation

Many participants in the GASB's pension research expressed interest in obtaining more information about how the unfunded accrued benefit obligation changes from year to year, the reasons for the changes, and the portion of the overall change attributable to each reason. For instance, they are interested in distinguishing the change in the unfunded obligation resulting from changes in benefit terms and other transactions within a government's control from the change that occurred because actual experience varied from actuarial assumptions.

One way to provide this information might be to add a third required financial statement—a statement of changes in the unfunded accrued benefit obligation. This financial statement would show how the unfunded obligation grew or diminished from one year to the next, disaggregating major types of changes by their source.

Questions for Users about Changes in the Unfunded Accrued Benefit Obligation

The arguments about whether or not additional information about the changes from year to year in the unfunded accrued benefit obligation should be presented in plan financial statements are set forth in paragraphs 12–20 of Chapter 7. You should consider these arguments with the intention of answering the following questions:

- 14. a. *Would requiring plans to present a statement of changes in the unfunded accrued benefit obligation provide you with useful information that you need about pension plans?***
- b. *What useful information, in particular, would such a financial statement provide to you?***
- c. *In what ways would that information be useful to you? How would you use it?***
- 15. a. *If you answered yes to Question 14a, what presentation would be most useful to you—(1) as a basic financial statement, (2) as a note disclosure, or (3) as RSI?***
- b. *Why would that presentation be most useful to you?***

WHAT INFORMATION DOES THE GASB NEED TO PROCEED WITH THIS PROJECT?

When the GASB sets standards, a crucial part of its “due process” activities is the publication of documents for public discussion and comment. The GASB relies on the comments of the people who prepare and audit financial statements to assess the technical accuracy and appropriateness of potential approaches to addressing accounting and financial reporting issues. The GASB often poses questions regarding critical issues in its due process documents.

The users of financial statements, on the other hand, are in the best position to help the GASB understand whether or not the information that would result from the potential approaches would be useful for fulfilling their need for governmental financial information. The substance of the comments from each of the GASB’s constituents is more important to the GASB’s deliberations than the total number of people for or against a certain approach. An Invitation to Comment is not an opinion poll, and the GASB’s ultimate decisions are not necessarily those with the most popular support.

You can help the GASB to complete this project by reviewing the issues raised in the Invitation to Comment and answering the questions posed throughout this supplement.

WHAT IS THE PURPOSE OF THIS SUPPLEMENT?

To help achieve its mission of setting accounting standards that result in information that is useful for making decisions, the GASB makes a concerted effort to communicate with the public in a more understandable and broadly accessible manner. In particular, the GASB occasionally uses “plain-language” supplements in conjunction with its due process documents.

This document is a plain-language supplement that accompanies an Invitation to Comment, *Pension Accounting and Financial Reporting*, discussing major issues related to the GASB’s existing standards for pensions. The intention of this plain-language supplement is to make it easier for you to participate knowledgeably in the GASB’s

standards-setting activities. This supplement attempts to achieve this goal by (1) presenting the issues with as little of the Invitation to Comment's technical and implementation-oriented vocabulary as possible and (2) focusing on the impact the issues may have on the information you find in government financial statements. This supplement focuses on situations that most typically occur and does not address certain circumstances that are less common. The complete discussion of the issues can be found in the Invitation to Comment, which should be read in conjunction with this supplement.

The GASB hopes that, as a result of its efforts to present these issues in less technical language, more users of governmental financial information will respond. The GASB will consider this feedback, and that expressed in a public hearing, during its future deliberations on the pension standards.

HOW CAN YOU SHARE YOUR OPINIONS WITH THE GASB?

There are two general ways to provide feedback to the GASB—submitting written comments and participating in GASB public hearings and user forums. In either case, it is essential to the Board to receive feedback from you that answers the questions presented above. You may also wish to address other issues raised in the Invitation to Comment.

If you would like to submit written comments to the GASB about these proposals, there are three ways you may do so:

- Internet-based questionnaire—your comments can be entered and submitted electronically using a questionnaire that can be found at <http://www.gasb.org/survey/cgi-bin/pafprpls.html>
- By email—send your comments to director@gasb.org
- By traditional mail—complete the form at the end of this supplement or include your comments in a letter and mail to:

Director of Research and Technical Activities
Project No. 34
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

Submissions are requested by July 31, 2009.

On August 26, 2009, the GASB is holding a public hearing at its offices in Norwalk, CT. The hearing will begin at 8:30 a.m.

If you wish to speak at the hearing, you should notify the GASB of your intent in writing and submit a copy of your comments, using the address above, no later than July 31, 2009. You can testify in person or via telephone. Please read the participation requirements in the notice of public hearing in the Invitation to Comment.

APPENDIX A: EXISTING ACCOUNTING AND FINANCIAL REPORTING STANDARDS FOR PENSIONS

How Are Pensions Reported in the Financial Statements of Government Employers?

For a government in a sole-employer or agent multiple-employer plan, the *annual pension cost* equals the ARC plus or minus certain adjustments if the employer's actual contributions in prior years differed from the ARC. The annual pension cost is the pension *expense* that a government reports in its accrual-based financial statements—the government-wide statements and the proprietary fund statements. Generally, the cumulative sum of differences between an employer's annual pension cost and the amounts *actually contributed* to the plan makes up a liability (or asset) called the *net pension obligation*. For an employer government participating in a cost-sharing multiple-employer plan, the annual pension expense is equal to the employer's *contractually required contribution* to the plan—the amount assessed by the plan for the period—which may or may not equal the ARC.

Under modified accrual in the governmental fund financial statements, an employer reports pension *expenditures* equal to *the amount contributed to the plan or expected to be liquidated with expendable available financial resources*. Because the governmental fund financial statements focus on current financial resources, they would not include the net pension obligation. Issues associated with the governmental fund financial statement recognition are not addressed in the Invitation to Comment.

The notes to the financial statements contain descriptive and explanatory detail in support of the information recognized in the statements. The notes identify the type of pension plan and the benefits it provides, and whether the plan issues its own financial report. Governments disclose information about their funding policy, such as the authority under which obligations to contribute to the plan are established, the required contribution rates of the government and its employees, and legal or contractual limitations on the maximum amount that can be contributed. Disclosures about the pension benefits themselves include the number and types of employees covered and the kinds of benefits provided. Issues associated with disclosures generally are not addressed in the Invitation to Comment.

Because governments participating in sole-employer or agent multiple-employer plans are individually responsible for financing the pensions of their own employees and retirees, these governments are required to provide additional information in their notes. The additional disclosures are intended to help users assess whether the governments are keeping pace with the ARC, the extent to which the resources set aside for paying pension benefits are sufficient or insufficient, and the methods and assumptions employed to conduct the actuarial calculations. The disclosures include the following:

- a. For the current year, annual pension cost and the dollar amount of contributions actually made. If the employer has a net pension obligation, it should also disclose the components of annual pension cost, the increase or decrease in the net pension obligation, and the net pension obligation at the end of the year.

- b. For the current year and each of the two preceding years, annual pension cost, percentage of annual pension cost contributed that year, and net pension obligation at the end of each year.
- c. The funded status of the plan; this is the same information governments would be required to disclose in a schedule of funding progress (see below), but only for the most recent valuation date.
- d. Information about actuarial methods and assumptions used in the valuations that the ARC, annual pension cost, and the funded status and funding progress of pension plans are based upon.

The financial statements and notes of the employer government are accompanied by RSI. (A government participating in a cost-sharing multiple-employer plan, however, does not have to present RSI as long as the plan issues its own separate financial report or is included in the financial report of another governmental entity.) Depending on the type of pension plan and whether it issues its own financial report, three types of RSI about defined benefit pension plans might be presented in a government employer's financial report: schedule of funding progress; schedule of employer contributions; and notes to the RSI schedules.

The schedule of funding progress provides information that is useful for judging how the funded status of a pension plan improved or deteriorated over time. For this purpose, the schedule shows the actuarial value of assets, the AAL, and the UAAL for the past three actuarial valuations. Asset value is divided by the AAL to produce the *funded ratio*. A funded ratio can be as low as zero (for a system with no assets) and as high as 100 percent or even higher (for a fully funded system, or one that actually has assets that exceed the AAL, respectively). The schedule also includes the total payroll of the current employees covered by the plan (the covered payroll), which is divided by the UAAL to calculate a ratio of unfunded liability-to-payroll.

The schedule of employer contributions compares a government's actual contributions to its pension plan with its ARC. If a government is aware of any factors that have a significant effect on the trend information in the two RSI schedules, such as improvements or reductions in pension benefit provisions, expansion or reduction of the eligible population, or changes in the actuarial methods, it adds an explanatory note to the schedules.

How Do Pension Plans Report?

The financial report of a defined benefit pension plan includes two financial statements. The *statement of plan net assets* includes information about the plan's assets, liabilities, and net assets as of the end of the fiscal year. The *statement of changes in plan net assets* provides information about additions to, deductions from, and net increases or decreases in plan net assets during the fiscal year. Additions generally include employer and member contributions and investment income. Deductions typically are benefits and administrative expenses.

Defined benefit pension plans should prepare note disclosures to give users information about plan description, accounting policies, contributions and reserves, and funded status.

Information intended to inform the user about the nature of the plan, its members, and the benefits it provides includes the classes of employees covered, the number of current members divided among retirees and beneficiaries currently receiving benefits, terminated members entitled to but not yet receiving benefits, and current active members, and a brief description of benefit provisions. A plan's summary of significant accounting policies should disclose the plan's policy with respect to recognition in the financial statements of contributions, benefits paid, and refunds paid, and a brief description of how the fair value of investments is determined.

Information that should be disclosed to help users understand how contributions are made to the plan and the amounts and purposes of the plan's reserves includes the authority under which the obligations to contribute to the plan are established, a description of funding policy and how contribution amounts are determined, required contribution rates, and balances in the plan's legally required reserves. Finally, plans should prepare a note disclosure containing the most recent information about their funded status and funding progress.

Plans should present both a *schedule of funding progress* and a *schedule of employer contributions*, covering the past six fiscal years. If a plan is aware of any factors that have a significant effect on the trend information in the two RSI schedules, such as improvements or reductions in pension benefit provisions, expansion or reduction of the eligible population, or changes in the actuarial methods, it adds an explanatory note to the schedules.

APPENDIX B: BACKGROUND ON THE GASB AND STANDARDS SETTING

What Is the GASB?

The GASB is the private, nonpartisan, nonprofit organization that is recognized as the setter of the standards that U.S. state and local governments follow when accounting for their finances and reporting them to the public. The GASB was founded in 1984 under the auspices of the Financial Accounting Foundation (FAF), which appoints the GASB's Board, raises its funds, and oversees its activities. The FAF also oversees the Financial Accounting Standards Board, which establishes standards for private-sector, for-profit and not-for-profit organizations. The mission of the GASB is to establish and improve standards of state and local governmental accounting and financial reporting that will:

- Result in useful information for users of financial reports, and
- Guide and educate the public, including issuers, auditors, and users of those financial reports.

Although the GASB does not have the power to enforce compliance with the standards it promulgates, the authority for its standards is recognized under the Code of Professional Conduct of the American Institute of Certified Public Accountants. The Code requires auditors to note any departures from GASB standards when they express an opinion on financial reports that are presented in conformity with generally accepted accounting principles. Also, legislation in many states requires compliance with GASB standards, and governments usually are expected to prepare financial statements according to those standards when they issue bonds or notes or otherwise borrow from public credit markets.

The GASB is composed of a full-time chair and six part-time members drawn from various parts of the GASB's constituency—state and local government finance officers, auditors, the accounting profession, academia, and persons who use financial statement information. The GASB has a professional staff drawn from similar constituencies as the Board. The staff works directly with the Board and its task forces, conducts research, analyzes oral and written comments received from the public, and drafts documents for consideration by the Board.

How Does the GASB Set Standards?

The GASB follows the set of “due process” activities enumerated in its published rules of procedure before issuing its standards. Due process is stringent and is designed to permit timely, thorough, and open study of financial accounting and reporting issues by the preparers, attestors, and users of financial reports in order to encourage broad public participation in the standards-setting process.

For many issues it addresses, the GASB:

- Appoints an advisory task force of outside experts
- Studies existing literature on the subject and conducts or commissions additional research if necessary
- Publishes for public comment a discussion document setting forth the issues and possible solutions
- Conducts public hearings and forums
- Broadly distributes an Exposure Draft of a proposed standard for public comment.

Significant steps in the process are announced publicly. The GASB's meetings are open to public observation and a public record is maintained. The GASB also is advised by the Governmental Accounting Standards Advisory Council, a 30-member group appointed by the FAF and representing a wide range of the GASB's constituents.

Additional information about the GASB and its activities may be found at www.gasb.org.

FINANCIAL STATEMENT USER RESPONSE FORM

Please complete this form and submit it to the GASB at the address listed on page 18 of this supplement. (Use additional pages if necessary.) Alternatively, you can submit your comments by using the Internet questionnaire at <http://www.gasb.org/survey/cgi-bin/pafrpls.html> or via email to director@gasb.org.

Name (required)	_____
Title	_____
Organization (required)	_____
Address (required)	_____
Address	_____
City, state, zip (required)	_____
Email (required)	_____
Telephone	_____

The Underlying Process

1. a. *Which process, if it were the focus of accounting and financial reporting for defined benefit pensions, would lead to the most useful information for you—(1) the incurrence of the obligation, (2) the financing of the obligation, or (3) both processes?*
- b. *Why would focusing on that process (or both) lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

Pension Liabilities and Expenses

2. a. *Which alternative would lead to the most useful information for you—1, 2, or 3?*
- b. *Why would that alternative lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

Effects of Future Changes

3. a. *Which alternative would lead to the most useful information for you—(1) including both projected service credits and salary increases when projecting benefits; (2) using projected service credits to project eligibility, but excluding projected service credits and salary increases when projecting benefits; or (3) using projected service credits to project eligibility, using projected salary increases when projecting benefits if the increases are part of an implied contract, but excluding projected service credits when projecting benefits?*
- b. *Why would that alternative lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

4. a. *Which alternative would lead to the most useful information for you—(1) excluding all ad hoc COLAs from projections of benefits or (2) including ad hoc COLAs if their amounts and timing are reasonably predictable?*
- b. *Why would that alternative lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

Discount Rate

5. a. *Which discount rate would lead to the most useful information for you—(1) long-term rate of return on pension plan assets, (2) risk-free rate, (3) a government's borrowing rate, or (4) average rate on high-quality municipal bonds?*
- b. *Why would that discount rate lead to the most useful information for you?*
- c. *In what ways would that information be useful to you? How would you use it?*

Actuarial Cost Methods

6.
 - a. *Assuming that governments use an approach that involves amortizing some parts of the unfunded accrued benefit obligation, what would lead to the most useful information for you—(1) reducing the number of acceptable actuarial cost methods that governments may choose from, (2) keeping the present six methods, or (3) adding more methods?*
 - b. *Why would your choice lead to the most useful information for you?*
 - c. *In what ways would that information be useful to you? How would you use it?*

7.
 - a. *If you believe that reducing the number of actuarial cost methods would lead to the most useful information for you, which methods would you select?*
 - b. *Why would those particular methods lead to the most useful information for you?*
 - c. *In what ways would that information be useful to you? How would you use it?*

Amortization Methods

- 8. a. *What would lead to the most useful information for you—(1) allowing a choice between open and closed amortization, and between level dollar and lever percentage amortization, or (2) specifying one or the other?***
- b. *Why would that lead to the most useful information for you?***
- c. *In what ways would that information be useful to you? How would you use it?***
-
- 9. a. *What approach to specifying a maximum amortization period would lead to the most useful information for you—(1) up to 30 years, (2) over the average remaining service period for employees, (3) applying different periods to different parts of the pension cost, or (4) immediate recognition of all pension costs?***
- b. *Why would that approach lead to the most useful information for you?***
- c. *In what ways would that information be useful to you? How would you use it?***

Valuation of Pension Plan Assets

- 10. a.** *What method of determining the value of plan assets would lead to the most useful information for you—(1) allow governments to recognize changes in values over a period of their choosing, (2) allow recognition over a specified period, or (3) require immediate recognition?*
- b.** *Why would that method lead to the most useful information for you?*
- c.** *In what ways would that information be useful to you? How would you use it?*
- 11. a.** *If you believe that answer (2) in Question 10a would lead to the most useful information for you, what do you believe that period should be?*
- b.** *Why would that specific period lead to the most useful information for you?*
- c.** *In what ways would that information be useful to you? How would you use it?*

Employers in Cost-Sharing Plans

- 12. a.** *Do the existing accounting and financial reporting requirements for governments participating in cost-sharing multiple-employer plans result in the information you need—yes, no, or partly?*
- b.** *If you answered no or partly, what alternative approach to accounting and financial reporting by governments in cost-sharing plans would lead to the most useful information for you—(1) existing requirements, but with additional disclosures by cost-sharing employers (please identify the additional disclosures you would need) or (2) requirements similar to those of sole and agent employers?*
- c.** *Why would that approach lead to the most useful information for you?*
- d.** *In what ways would that information be useful to you? How would you use it?*

Liabilities of the Plan

- 13. a.** *What approach would lead to the most useful information for you regarding pension plans—(1) reporting only liabilities arising from member payments due but not yet paid or (2) reporting the accrued benefit obligation as a liability?*
- b.** *Why would that approach lead to the most useful information for you?*
- c.** *In what ways would that information be useful to you? How would you use it?*

Changes in the Unfunded Accrued Benefit Obligation

- 14. a. *Would requiring plans to present a statement of changes in the unfunded accrued benefit obligation provide you with useful information that you need about pension plans?***
- b. *What useful information, in particular, would such a financial statement provide to you?***
- c. *In what ways would that information be useful to you? How would you use it?***
- 15. a. *If you answered yes to question 14a, what presentation would be most useful to you—(1) as a basic financial statement, (2) as a note disclosure, or (3) as RSI?***
- b. *Why would that presentation be most useful to you?***

THANK YOU!

Please return to:

Director of Research and Technical Activities
Project No. 34
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116