



PERISCOPE

Public Employee Retirement Systems

GASB's Preliminary Views on New Pension Accounting Rules

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On June 16, 2010, the Governmental Accounting Standards Board (GASB) released its much-anticipated Preliminary Views (PV) document proposing significant changes to the current standards for pension accounting and financial reporting by government employers. At this point, the PVs are general principles and concepts rather than detailed proposed requirements for pension accounting. These PVs are a step toward an Exposure Draft of a Statement of Government Accounting Standards that would modify the current standards set forth in Statements No. 25 and 27.

The objective of the PVs is to present GASB's current views on what it believes are the most fundamental issues related to employer recognition and measurement of pensions in order to **obtain comments from constituents before developing more detailed proposals** for changes to existing accounting standards. Overall, the PVs represent a sharp departure from current accounting standards.

The nature of a government's pension obligation

The PVs classify pension benefits as a form of compensation promised by governments to their employees in exchange for work

performed. The PVs reflect the Board's view that the employer remains primarily responsible for the remaining unfunded portion of the obligation, and the pension plan is primarily responsible for the portion of the obligation covered by accumulated assets. The employer is secondarily responsible for the funded portion of the obligation, as well. This is a departure from the current GASB disclosure requirements that center around the annual required contribution (ARC) and net pension obligation (NPO), as these measures, in GASB's view, imply the employer's liability has been transferred to the plan and replaced by annual funding requirements.

Actuarial accrued liability is replaced

Total pension liability is the portion of the present value of all future projected benefit payments allocated by the Entry Age Normal cost method to employee service provided in prior years. Projected benefit payments will reflect future salary increases, future service credits, automatic COLAs, and certain ad hoc COLAs. *The total pension liability must be calculated using the level percent of pay entry age actuarial cost method for all plans. A single weighted-average discount rate would be used to value the payments.* It would be weighted based on (1) the long-term expected rate of return on the plan assets, to the extent that projected benefit payments and expenses will be covered by current assets and future contributions, including those from the employer and current employees; and (2) a high-quality municipal bond index for benefits payable beyond that point.

The calculation of the total pension liability differs from the current GASB standards by recognizing ad hoc COLAs, potentially incorporating dual-level discounting, and mandating the entry age actuarial cost method. The total pension liability may end up being greater than the actuarial accrued liability (AAL) using current accounting rules.

Net pension obligation is replaced

The Board considered but rejected the current concept of an NPO, which essentially represents the cumulative difference between an employer's actual and required contributions. Instead, the PVs introduce the concept of net pension liability, basically

GASB'S PRELIMINARY VIEWS: IN BRIEF

The PVs pertain solely to the context of accounting and financial reporting, not to the context of the funding of pension benefits. The changes considered are the following:

- Accounting and funding standards would be separated.
- A net pension liability would be shown on the employer's financial statements, rather than as supplemental information.
- The concept of a net pension obligation (NPO) would be rejected.
- Changes in the net pension liability would be amortized over shorter periods.
- Three separate sets of rules would apply for amortizing changes in (1) active liabilities, (2) retired liabilities, and (3) assets.
- Acceptable asset smoothing would change.
- A single discount rate would be used based on when expected assets are projected to run out.
- Plans would use the entry age actuarial cost method for disclosures.
- Employers participating in cost sharing plans would recognize a proportionate share of net pension liability and expense calculated in the same general manner as sole and agent employers.

the difference between the total pension liability and the plan's fair value assets on the measurement date. The net pension liability would be reported in the employer's financial statements.

Changes in amortization payment methodology

Three primary changes in net pension liability may be amortized over future years in pension expense: (a) differences between expected and actual experience, sometimes called gains and losses; (b) changes in assumptions; and (c) plan changes. GASB believes it is appropriate to apply a single method to all three of these types of changes in order to avoid unnecessary complexity. However, changes associated with (a) active members, (b) inactive members, and (c) assets are treated differently. Changes associated with active members would be amortized over a weighted average of their remaining service life. This could be 12 to 15 years, or fewer, depending on the weighting basis and plan demographics. Changes associated with inactive members (including retirees) would be recognized as a pension expense immediately in the period of the change.

Differences between assumed asset returns and actual returns would be deferred as long as the accumulated deferred inflows or deferred outflows did not exceed 15% of the fair value of pension plan investments. Any amount beyond 15% would be incorporated into the expense calculation immediately. Methods smoothing the differences between expected and actual returns over a specified number of years were rejected because they are not consistent with GASB's underlying belief that such differences are expected to offset each other over time.

Cost-sharing multiple-employer pension plans

Cost-sharing employers pool their assets and their obligations and share a single actuarial valuation. Contributions from one employer may be used to pay the benefits of another employer. GASB's PVs state that each participating employer in a cost-sharing plan should recognize its estimated proportionate share of the collective net pension liability and pension expense calculated in the same general manner as for agent and sole employers. The PVs do not specify an allocation methodology, but the Board is considering using the employer's share of the total annual contractually required contributions to the plan. In addition, an adjustment would be included to reflect the period-to-period change in an employer's proportionate share of the totals.

What might be the impact of the PVs?

If the views expressed by the PVs become the new accounting standards, they may have a significant impact on government employers' financial statements. They also will change the way accounting numbers are used to evaluate a plan's status.

The PVs repeatedly state that they are made solely within the context of accounting and financial reporting, not within the context of the funding of pension benefits. They are not intended to be funding standards. Although accounting and funding requirements have always been separate, many governments contribute the ARC as determined under GASB No. 27. In most circumstances, contributing the ARC has been a sound funding policy. Under the current standards, if an employer always funded the ARC, the NPO would be equal to \$0 and result in no impact in the employer's financial statements.

Should the PVs become standards, it will be critical to separate thinking for "funding" and "accounting." Employers may need to develop new funding policies for determining their annual cash contribution. Contributing an amount equal to the annual pension expense as developed in the PVs may not be a practical option, because some items incorporated into the expense calculation could be one-time spikes (e.g., immediate recognition of cumulative asset losses outside the 15% corridor or immediate recognition of retiree assumption changes).

This would not be the first time public plans had accounting numbers inconsistent with funding. The numbers from GASB No. 5 were nearly always inconsistent with the funding numbers. When GASB No. 25 and 27 replaced GASB No. 5, one of the objectives was to have accounting statements that were consistent with plans' funding policies.

GASB's goal is to improve the accountability, decision usefulness, and interperiod equity provided by accounting statements. Major accounting and financial statement changes for government employers are likely to be on the horizon. The PVs provide the best insight into GASB's current thinking. It is important to be aware of what is being proposed and how the potential changes may affect government financial statements. Financial reporting and funding standards may no longer be related. Public plans may need to develop sound funding policies independent of the accounting standards (as well as be able to explain the differences between the two). For further discussions about how the PVs could affect your system/government agency, contact your Milliman consultant.

GASB is inviting comments on its PVs and has specifically included a list of questions in the document for respondents. Written comments regarding the Preliminary Views are due by Sept. 17, 2010, with three public hearings scheduled to follow in October 2010. An Exposure Draft will be issued after the comment period. This is your opportunity to be heard. More information is available at www.gasb.org.