

# GASB issues its Preliminary Views on Pensions

Bob Scott, Chair, GFOAT FRRR Committee

On June 18, 2010, the Governmental Accounting standards Board issued their Preliminary Views (PV) on Pension Accounting and Financial Reporting for Employers. This document is available on the GASB website at [www.gasb.org](http://www.gasb.org) and has a comment deadline of September 17, 2010. A public hearing on the subject will also be held by GASB at the DFW Hyatt at DFW airport on October 12, 2010. GFOAT's Financial Reporting and Regulatory Requirements (FRRR) committee will be preparing a response on behalf of its membership based on a meeting/conference call hosted by the City of Richardson City Hall/Convention Center on Friday, August 13, 2010 9:00-11:00 a.m.. Members are encouraged to participate in GFOAT's response.

A summary of the changes proposed by the PV is included in Exhibit 1. The impacts of the proposed changes can be summarized using the acronym "RLM" Responsibility, Liability and Methodology. This article will briefly discuss each of these impacts.

## RESPONSIBILITY

In the public sector providing pension benefits to retirees requires a partnership between two separate and independent entities: the employer and the pension plan itself. The employer has the responsibility to determine the benefit levels and to responsibly fund the plan at those benefit levels, and the plan has the responsibility to invest both employer and employee contributions wisely and to ensure adequate resources to pay benefits through diligent governance of the actuarial process. Financial reporting should recognize those roles and not over or under emphasize the importance that each entity plays in providing pension benefits.

Traditionally, GASB has focused users of financial statements on whether the employer is making their actuarially required contribution (ARC) by recognizing a liability in their financial statements only if their annual contributions to the plan were less than the ARC. On the other side of the transaction, pension plan reporting focused users on the assets available to pay benefits and does not recognize a liability for any funding shortfalls, i.e. actuarial liabilities being greater than assets. Current standards for plan reporting also do not recognize a receivable for the difference between the ARC and the employer's actual contributions even though the employer must recognize a corresponding liability. With the publication of the PV, GASB is squarely placing responsibility for the entire funding process with the employer by requiring any unfunded portion of the plan to be recognized immediately in their financial statements.

## LIABILITY

Perhaps the largest single impact of the proposed accounting changes is the requirement for the employer to recognize in the Statement of Net Assets a liability for the plan's unfunded liabilities. This liability is calculated as the actuarial accrued liability minus the actuarial value of assets and for many cities will represent tens of millions if not hundreds of millions of dollars. Recognition of this liability has several impacts on the employer:

- ❖ Disconnection of the Accounting from the Funding. It will now be virtually impossible to focus the financial statement user on whether or not the government is making the ARC because the expense recognized in the financial statements will be driven by changes in the liability and will no longer be tied to the ARC.
- ❖ Volatility of the Liability and Related Expense. The actuarial unfunded liability is a subset of the actuarial process and because it is derived from two much larger numbers it will be very volatile in nature. For example if an entity has \$100 million in actuarial liabilities and \$95 million in actuarial assets, it is 95% funded and every 1% increase in the actuarial liability without a corresponding change in the asset will result in a 20% change in the liability recognized by the employer. Ironically the worse the funded status, the less the volatility since a 1% increase in a 50% funded plan would only result in a 2% increase in the liability.
- ❖ Employer and their Auditor are now Responsible for the Accuracy of the Liability. As discussed above, the liability to be recognized by employers is potentially huge and volatile and will often be one of the largest single numbers in the financial statements. Given this very material number, the employer's auditor will naturally want some assurance that it is fairly stated. However how able or qualified is the employer to provide this assurance given that:
  - The employer does not have any direct knowledge of the qualifications or references of the actuary since they did not choose the actuary (the pension plan did).
  - The employer does not typically approve and may not have even be asked regarding the reasonableness of the assumptions used for the valuation since that is the responsibility of the pension plan.
  - The employer's accounting systems did not generate the underlying accounting data used for the valuation and the employer has no direct knowledge or control regarding the internal controls over that accounting system.

## METHODOLOGY

In addition to the liability issue, GASB's proposals significantly limit the options and flexibility currently allowed by GASB 25 and 27. Many of these changes are in direct reaction to what some perceive as abuses by some employer or pension plans that used overly optimistic assumptions or unreasonably long amortization periods in order to keep the employer's ARC artificially low. The major changes are:

- ❖ Discount Rate. Under previous guidance, the actuary was able to discount future liabilities by the expected rate of return on the plan. GASB is now proposing blended rate in that the long term rate of return can only be used for those future payments that are expected to be made with funds available in the plan. If the plan is expected to at some point to run out of money and in essence become a pay as you go plan, then a rate equal to a high quality municipal index is mandated. This will require additional cash flow analysis on the part of the plan's actuary but how much it would increase the unfunded liability would depend not only on "if" but also when the shortfall was expected to occur. For example, a shortfall projected for 2038 may not increase the liability significantly since a very small percentage of future payments would be discounted at the lower rate but a shortfall projected to begin in 2015 could dramatically increase the liability. This approach could also significantly increase the volatility of the liability particularly due to investment downturns.
- ❖ Actuarial Method. The proposal requires use of Entry Age actuarial method which is used by about 75% of all public plans nationwide. For those of us whose only plan is with TMRS (which uses Projected Unit Credit) that means our accrued liabilities will in most cases be higher than it is currently reported. Entry Age is a preferred funding method for many plans because it produces a very stable, level contribution amount overtime, it is not, however, a good measure for the benefits earned to date which may not make it the best method for recording a liability in the employer's financial statements.
- ❖ Amortization Techniques. Rather than the current standard, which allows the use of level dollar amount (LDA) and an amortization of up to 30 years, GASB is proposing allowing only Level Percent of Payroll (LPP) with an amortization period (for those items that allowed to be amortized) of the average remaining service life of covered employees. For most plans, this is expected to be 10-15 years. Again, limiting the amortization options and shortening the amortization period appears a reasonable approach but there are subtle implications to the proposal. The first issue is that LPP is the least understood of the amortization methods and given its back loading nature will produce lower contributions in the early years than the better understood Level Dollar Amount (LDA) even with longer amortization periods. For example, 15 year LPP at 4%

covered payroll growth will generate a lower payment for the first three years compared to 20 year LDA. The second issue is that GASB has picked an amortization period that by its nature will change every year. In addition to the “understandability” issues this creates, one could also argue that many actuaries will interpret an ever changing amortization period as “open” or perpetual amortization. health

## CONCLUSION

Although, there are many positive aspects to the PV, there also areas of concern including the loss of funding focus for employer reporting, the volatility of the unfunded liability when it is reported in isolation from the remainder of the actuarial valuation, and the lack of recognition of the distinct and separate roles of the employer and the plan. True progress can be made if GASB would shift its focus to recognizing this partnership and improving pension reporting for both the employer and the plan.

GFOAT intends to both respond to the PV and to testify at the GASB Public hearing at DFW. We encourage all members to participate in the crafting of the response and testimony. Many thanks to Richardson for hosting the meeting on August 13, 2010 to determine our response and we encourage all members to participate in our response.

## Exhibit 1-Proposed Changes from GASB 25 & 27

ISSUE	GASB 27	PV
Primary obligation for unfunded benefits	Not stated	Employer
Employer liability	Unfunded contributions	Unfunded actuarial accrued liability
Projections	Additional statutory or contractual agreement(s) to provide pension benefits through the plan that are in force at the actuarial valuation date. (collective-bargaining agreements and agreements to provide ad hoc COLAs and other types of increases)	<ul style="list-style-type: none"> <li>• Automatic COLAs</li> <li>• Quasi-automatic COLAs</li> <li>• Future salary increases</li> <li>• Future service credits</li> </ul>
Discounting	Long-term rate of return	Blended rate that combines <ul style="list-style-type: none"> <li>• Long-term rate of return (funded)</li> <li>• High-quality municipal bond index rate (unfunded)</li> </ul>
Actuarial cost-allocation method	<ul style="list-style-type: none"> <li>• Entry age</li> <li>• Frozen entry age</li> <li>• Attained age</li> <li>• Frozen attained age</li> <li>• Projected unit credit</li> <li>• Aggregate</li> </ul>	Entry age
Amortization method	Level dollar or Level percentage of pay	Level percentage of pay
Amortization period for factors other than projected earnings	30 year maximum	Estimated remaining service life (average for active employees to approximate individual lives)

Amortization of projected earnings	30 year maximum	Deferral within 15 percent corridor/otherwise immediate recognition
Cost-sharing employers: liability	No liability beyond unfunded contractually required contributions	Proportionate share of unfunded actuarial accrued liability
Cost-sharing employers: Expense	Contractually required contributions	Proportionate share of pension cost
Calculation date	Any date	Any date with update to fiscal year end