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# GASB Issues Preliminary Views on Pension Accounting and Financial Reporting by Governmental Employers

*The Governmental Accounting Standards Board (GASB) has issued its preliminary views on accounting by and for pension plans in the governmental sector. The document is to a large degree a compilation of the "tentative decisions" made by the GASB as it has considered comments in response to questions posed last year. If incorporated in new accounting standards, GASB's views will result in some significant changes from existing pension accounting practices in the public sector. Commenters are requested to contact GASB by September 17, 2010, and hearings will be held in Dallas, New York and San Francisco in October. An exposure draft of a new standard is expected to follow.*

## Background

GASB is responsible for developing accounting and financial reporting standards for state and local governments. Two GASB statements from the mid-1990s govern the reporting of pension information. GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* deals with financial reporting by plans. GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, covers financial reporting by plan sponsors.

Since the effective dates of Statements 25 and 27, there has been significant debate over the theoretical underpinnings of pension accounting in both the public and private sectors. As a result, GASB decided in 2006 that it would undertake a comprehensive review of financial reporting by and for pension and postretirement benefit plans in the U.S. The project began in earnest in 2008 with a review of existing standards and the criticisms that have been made of them. An "Invitation to Comment" issued in March 2009 asked respondents to address several specific aspects of pension accounting in the public sector. As GASB reviewed the responses, it formulated a number of tentative decisions on the issues raised, which have now been set forth formally in the Preliminary Views. GASB will review feedback and issue an exposure draft, although no timetable has been set for its release.

### Preliminary Views

GASB's Invitation to Comment solicited feedback on a list of specific issues. The Preliminary Views are presented similarly. Specifically, commenters are asked whether they agree with GASB's tentative decisions, which are reported in some depth in the document and include the following –

- Employers are responsible for the differences between defined benefit pension obligations and the net assets available to pay them.

- For sole and agent employers, an employer's net pension liability, which is the difference between the pension liability and net assets referred to above, may be measured with sufficient reliability to be included in the employer's basic financial statement.

***BUCK COMMENT.*** *This treatment would differ significantly from that prescribed by current standards, which relegate such liabilities to the notes or the required supplementary information.*

- Regarding the measurement of pension liabilities for financial reporting purposes –
    - These liabilities should reflect all automatic COLAs, ad-hoc COLAs that do not differ substantively from automatic COLAs, and future pay increases and service accruals for current active members. GASB also asks for suggestions for criteria to be used to identify ad-hoc COLAs that are substantially equivalent to automatic COLAs.
    - Projected benefit payments should be discounted at a single rate that produces the same result obtained by discounting benefits expected to be covered by current and expected future plan assets at the expected long-term rate of return on plan assets, while discounting projected benefits in excess of those that can be provided by current and expected future plan assets at a high-quality municipal bond index rate.
    - The attribution of benefits to periods of service should be made in accordance with the individual level-percentage-of-pay entry age normal cost method.

***BUCK COMMENT.*** *These are several of the most important of the tentative decisions made by GASB. In deciding to make the individual level-percentage-of-pay entry age normal cost method the basis for financial reporting, and to reflect expected future pay increases and service accruals in financial measurements, GASB has rejected the arguments put forth by advocates of a financial economics approach to financial reporting, who had argued for the use of the accrued benefit (unit credit) cost method as the basis for financial reporting. An even stronger rejection of the financial economic school of thought is GASB's tentative decision to permit the expected long-term rate of return to continue to serve as the basis for financial reporting to the extent that current and expected future assets are expected to cover projected future benefit payments. Advocates of a financial economics approach argued for the use of current rates on low- or no-risk assets for this purpose. The discount rate basis proposed in this tentative decision is similar to the one mandated in GASB Statement 45.*

- The effects of deviations of experience from actuarial assumptions (except investment return), changes in assumptions, and plan amendments should be recognized over periods representative of the expected remaining service lives of affected participants, taking into account separately their impact on active and inactive members. To the extent that such changes relate to the past service of active members, the amortization period would be the average expected remaining service life. To the extent the changes relate to the past service of inactive members, such changes would be recognized immediately. Expected earnings on plan assets are to be incorporated as an element of pension expense, and differences of actual earnings from expected earnings on assets that are not more than 15% of total plan assets are to be deferred for later recognition.

***BUCK COMMENT.*** *This is an indication of the extent to which actuarial calculations made for accounting purposes under the standard eventually to be issued by the GASB may ultimately differ from those made for funding. Under present standards, public-sector employers may base both funding and accounting calculations on a variety of funding methods and use amortization policies and asset smoothing techniques that meet fairly liberal criteria. The most important aspect of the decoupling of funding and accounting for which the GASB seems to be headed is that balance sheet accruals will not be avoidable simply by adhering to a funding policy that meets certain parameters set forth in an accounting standard. Also, the calculation of pension expense envisioned by GASB appears to be similar to that made under FASB standards for private-sector plan sponsors, with a separate interest component and straight-line, piece-wise amortization of the unfunded obligation, although the actuarial cost method chosen by GASB is not the one selected by FASB for this purpose.*

- Cost-sharing employers should recognize their "proportionate shares" of the collective net pension liability, pension expense, and deferred pension outflows (inflows) of the pension plans to which they belong. GASB asks for suggestions as to how "proportionate shares" should be determined.

***BUCK COMMENT.*** *If maintained, this will lead to substantially greater complexity in pension accounting for public-sector cost-sharing employers than under present standards, particularly for participating units in cost-sharing plans that do not have a uniform fiscal year and will be adjusting results to different fiscal-year-end dates, as described below.*

- Accounting valuations should be made not less frequently than every two years, and the results of such valuations should be adjusted to the end dates of plan sponsors' fiscal years if not made as of those dates. "Professional judgment" should be used to make the adjustment to fiscal year-ends, as well as to determine whether a new measurement should be made in lieu of an adjustment to the fiscal year-end.

***BUCK COMMENT.*** *The direction of GASB's thinking is clearly toward a standard that would lead many governmental entities to make separate valuations of their pension plans for accounting and funding purposes, which is not presently a common practice in the public sector. Actuarial firms serving public-sector entities are likely to be pressed by their clients to look for economies of scale in the preparation of the separate valuations.*

## Conclusion

Those wishing to respond to GASB's preliminary views in writing and/or by testifying at the October public hearings must contact GASB by September 17, 2010.

Buck's consultants are available to help you understand the potential implications of the Preliminary Views on your retirement system, and to keep you informed of continuing developments as the GASB continues its revision of its current accounting standards for pension plans.