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GASB Issues Exposure Drafts of Amended Standards for Public Retirement Systems

GASB has issued exposure drafts of extensive revisions to its current standards on accounting by and for pension plans maintained by governmental entities (GASB Statements Nos. 25 and 27). As expected, the exposure drafts call for extensive changes from current public-sector pension accounting practices. GASB will accept written comments until September 30, 2011 and hold public hearings in October. GASB's goal is to have final standards in place by June 2012.

Background

The Governmental Accounting Standards Board (GASB) is responsible for developing accounting and financial reporting standards for state and local governments. GASB issued two statements in the mid-1990s setting forth present requirements for 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.

In the years since GASB adopted Statements 25 and 27, there has been significant debate over the theory and practice 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 United States. The project began in earnest in 2008 with a review of existing standards and the criticisms that have been made of them. GASB issued an "Invitation to Comment" in March 2009 asking respondents to address several specific aspects of pension accounting in the public sector. In June of 2010, GASB released its *Preliminary Views* on needed revisions to its existing pension accounting standards. (See our June 29, 2010 *For Your Information*.) *Preliminary Views* described GASB's tentative decisions on changes to existing standards as well as areas in which GASB wanted additional feedback from the public before it made decisions as to how to proceed. Public comment on the *Preliminary Views* formed GASB's subsequent discussions.

The Exposure Drafts

On July 8, 2011, GASB issued exposure drafts of amended Statements 25 and 27. To a large extent, the exposure drafts reflect the positions taken in the *Preliminary Views*, although they incorporate some significant

changes and amplifications. GASB's fundamental conclusion that a sole or agent employer should show on its basic financial statement a net pension liability equal to its pension liability less the value of the net assets available to pay for pension benefits is unchanged. Also unchanged is the conclusion that the calculation of the pension liability should be made in accordance with the individual level-percent-of-pay entry age normal funding method.

***BUCK COMMENT**. Both of these are departures from the current standards, which present pension information entirely in notes or required supplementary information and permit a variety of funding methods to be used as the basis for accounting disclosures.*

Areas in which the exposure drafts have changed or clarified the *Preliminary Views* include the following:

- **COLA Incorporation**. GASB's *Preliminary Views* provided that both automatic cost-of-living adjustments (COLAs) as well as COLAs that were "not substantively different from" automatic COLAs should be included in the valuation of pension liabilities. GASB also sought feedback in the *Preliminary Views* on the characteristics that should be used to determine whether *ad hoc* COLAs were effectively automatic ones. In the exposure drafts, this question is answered: "the historical pattern of granting the changes, the consistency in the amounts of the changes or in the amounts of the changes relative to a defined cost-of-living or inflation index, and whether there is evidence to conclude that changes might not continue to be granted in the future despite what might otherwise be a pattern that would indicate such changes are substantively automatic."

- **Discount Rate**. In the *Preliminary Views*, GASB proposed that the discount rate used in financial reporting calculations be set equal to the expected long-term rate of return on plan assets to the extent that projected benefits would be covered by current and projected future plan assets. To the extent current and expected future assets are projected to be insufficient to pay projected benefits, the *Preliminary Views* called for them to be discounted at "a high-quality municipal bond index rate." The exposure drafts have clarified that the municipal bond index rate to be used for this purpose is an index rate for a 30-year, tax-exempt municipal bond rated AA/Aa or higher.

- **Pension Expense**. In the *Preliminary Views*, GASB set forth a process by which a pension expense figure would be calculated that would effectively supplant the "annual required contribution" specified in the current GASB standards. The new pension expense amount could – and in most cases would – differ from the calculation of funding requirements made under most public retirement systems' current funding policies. GASB appears to have joined its private-sector counterparts at the Financial Accounting Standards Board in effectively requiring separate valuations to be performed for funding and financial disclosure for most public retirement systems. In the exposure drafts, GASB retains the requirement that systems should calculate a pension expense figure using the prescribed funding method (entry age normal) and discount rates just described. GASB also retains the rule that different segments of the net pension obligation should be recognized in net pension expense over different periods of time. However, in the

exposure drafts, GASB abandons some of the more troubling guidance provided in the *Preliminary Views* on the recognition of certain changes in the net pension liability. In general, the exposure drafts call for immediate recognition in pension expense of changes in benefit terms or changes in the pension liabilities of inactive employees and deferred recognition of changes in the pension liabilities of active employees over a closed period that is "representative" of active participants' remaining service lives. The particularly complex treatment of asset gains and losses proposed in the *Preliminary Views*, which would have treated gains and losses outside of a 15% corridor differently from those within it, has been replaced with a simpler requirement that asset gains and losses be recognized over a five-year period.

- **Cost-Sharing Pension Plans**. In the *Preliminary Views*, GASB advanced the idea that cost-sharing employers should recognize the "proportionate shares" of the collective net pension liabilities of the plans to which they belong in their financial statements and requested opinions as to how such proportionate shares should be determined. The exposure drafts specify that a cost-sharing employer should determine its proportionate shares by the proportion that the value of the employer's future contributions is of the total value of future employer contributions to the system. The effects of changes in this proportion from year to year and differences between an employer's actual employer contributions and its proportional share of contributions are recognized in the pension expense amounts calculated under the proposed new standards. The exposure drafts also take account of "special funding situations" in which parties other than participating employers share in the responsibility for making contributions to a cost-sharing plan. The manner in which the involvement of these other parties is reflected depends upon whether the outside party's obligation to make contributions is conditional or unconditional.
- **Timing of Valuations**. The exposure drafts retain the *Preliminary Views'* requirement that valuations be performed at least every two years, and that valuation results be rolled forward to the reporting date to the extent the valuation dates differ from the date of the most recent actuarial valuation.
- **Disclosures**. The *Preliminary Views* were largely silent on disclosures that GASB should require under revised standards. The exposure drafts, by contrast, require the disclosure, in notes to financial statements, of significantly more information than the current standards require regarding plans, their funded positions, the components of pension expense, and changes in the net pension liability. The exposure drafts mandate considerable detail in the description of actuarial assumptions, which as currently must be selected in accordance with Actuarial Standards of Practice, including the identification of experience studies and other sources used in the setting of assumptions. The exposure drafts require particularly detailed information concerning the basis for the selection of the assumed discount rate, along with an indication of the effect of 100-basis-point changes in either direction on the net pension liability disclosed.

Effective Dates

If adopted, the exposure drafts would apply for periods beginning after June 15, 2012 for most large systems (i.e., those with $1 billion or more in assets) that are not cost-sharing multiple employer plans. For all other public retirement systems, they would take effect for financial reporting periods beginning after June 15, 2013.

Conclusion

Those wishing to comment on the exposure drafts in writing and/or by testifying at the October public hearings must contact GASB by September 30, 2011.

Buck's consultants are available to help you understand the potential implications of the proposed new standards 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.