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GASB Adopts Extensive Revisions of Accounting Standards for Public Retirement Systems

On June 25, the Governmental Accounting Standards Board adopted new standards for accounting by and for public sector retirement systems. Statement No. 67, *Financial Reporting for Pension Plans,* and Statement No. 68, *Accounting and Financial Reporting for Pensions,* replace current GASB Statements Nos. 25 and 27, which have been in effect since the mid-1990s. The provisions in Statement 67 are effective for financial statements for periods beginning after June 15, 2013. The provisions in Statement 68 are effective for fiscal years beginning after June 15, 2014.

Background

The Governmental Accounting Standards Board (GASB) is responsible for developing accounting and financial reporting standards for state and local governments. The GASB issued two statements in the mid-1990s setting forth 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 the 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, the GASB decided in 2006 that it would undertake a comprehensive review of financial reporting by and for public sector retirement systems in the United States. The project began in earnest in 2008 with a review of the existing standards and the criticisms made of them. The GASB issued an "Invitation to Comment" in March 2009, asking respondents to address several specific aspects of public sector pension accounting. In June 2010, the 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 the GASB's tentative decisions on changes to be made to existing standards as well as areas in which GASB wanted additional feedback from the public before it decided how to proceed. Public comment on *Preliminary Views* formed the GASB's subsequent discussions, which were summarized more formally in exposure drafts of amended Statements 25 and 27 issued in July 2011. (See our August 2, 2011 For Your Information.) Statements 67 and 68 are to a large degree the same as the exposure drafts, but they also reflect some significant changes that, for the most part, are helpful to subject retirement systems and their sponsors.

The New Framework for Public Sector Pension Accounting

The new approach to the measurement and reporting of costs and liabilities for public sector pension plans is grounded in the GASB's *Concept Statements,* which are statements of fundamental principles. It also reflects the thinking embodied in the GASB's 2006 White Paper, *Why Governmental Accounting and Financial Reporting Is—and Should Be—Different.*

Public sector plan sponsors will find the requirements imposed by the GASB challenging on several levels. The new requirements preserve many aspects of traditional actuarial methodology while addressing:

- The need for greater transparency and more straightforward recognition of liability increases and costs
- The need to enhance the comparability of reporting from plan to plan
- The need for significantly expanded disclosure

Here are the basics:

- Governmental employers will have to show the net pension liabilities of their retirement systems on their balance sheets. A retirement system's net pension liability is the excess of its accrued liability over the market value of assets.
- In computing the net pension liability, the sole acceptable actuarial cost method will be the individual level-percent-of-pay entry-age normal method. Importantly, the "pure" version of this cost method must be used, rather than variants under which normal cost is determined on the basis of benefit provisions that differ from those applicable to some participants.

INSIGHT

One of the most significant changes made by the new standards is the removal of the incentive to maintain funding in line with a GASB-defined expense. In the future, the sponsor of a system with a net pension liability will have to include it in its financial statements, regardless of how conscientious it has been about making contributions. This may be contrasted with present standards, which require disclosure of a net liability only to the extent that a "net pension obligation" (NPO) exists. An NPO arises only where there has been underfunding relative to a GASB-defined "annual required contribution." Add to that the new requirement to use a single funding method for financial reporting purposes and it is clear that the GASB has, to a great degree, divorced funding from accounting in Statements 67 and 68.

- The computation of net pension liability must be based on a discount rate that is equal to the expected long-term rate of return on plan assets to the extent that current and expected future plan assets are projected to cover benefits. To the extent that current and expected future plan assets are projected to fall short of covering benefits, benefits not expected to be supported by retirement system assets must be discounted at a yield or index rate for 20-year, tax-exempt general obligation bonds with an average rating of AA/Aa or higher (or equivalent quality on another rating scale). The requirement to discount some benefits using an expected rate of return and others using a current yield on 20-year bonds will result in the use of a so-called "blended" discount rate for many systems. Projection of expected future assets is to be made taking into account the five most recent years of contributions by the entities responsible for funding a retirement system—in particular, the extent to which actuarially determined contributions were made in that period.

INSIGHT

As recently as when the exposure drafts of the new standards were issued last year, the GASB had not specifically identified the characteristics of the bond yields or indexes to be used in the calculation of a blended discount rate where one is required, as it now has in the new standards.

- A detailed reconciliation of the change in the net pension liability from one year to the next is to be presented for balance sheet purposes. This change in net pension liability constitutes pension expense for the period. Pension expense is defined to fully reflect certain changes in the components of net pension liability and to defer recognition of other components; these other components will constitute "deferred inflows and outflows of resources" and will be reported separately in the financial statements. Items to be fully reflected include service cost (i.e., normal cost under the mandated entry-age normal cost method), interest on the net pension obligation, and the effects of plan amendments. The effects of demographic gains and losses and changes in actuarial assumptions are to be recognized over a closed period equal to the average of the expected remaining service lives of all employees (that is, active employees and inactive employees, including retirees). The effects of investment gains and losses are to be recognized in expense "using a systematic and rational method" over a closed five-year period.

INSIGHT

The definition of pension expense in the final standards uses amortization methods that are far less problematic than those proposed in the expense definitions set forth in *Preliminary Views* and the exposure drafts. All amortization periods used in the determination of expense under the final standards are closed amortization periods, marking a further departure from current GASB standards and from practices that some public sector plan sponsors will continue to follow in determining contribution levels.

- The amount of information to be included in the notes and required supplementary information in financial reports prepared under the two new standards is significantly greater than what is required under Statements 25 and 27. Of particular note is the extensive documentation that must be provided about the establishment of the discount rate used in the calculations. This includes assumed future cash flows, asset allocations, real returns on asset classes, and the effects of using a discount rate that is 100 basis points higher or lower than that developed in accordance with the requirements of the new standards.

Cost-Sharing Plans and Participating Employers

Early indications of the likely requirements of the developing new standards for public sector pension accounting were particularly alarming for so-called cost-sharing systems and the employers participating in them. Under current GASB standards, an employer participating in a cost-sharing system reports only general information about the plan and the extent to which it is required to contribute to it.

In *Preliminary Views* and the subsequent exposure drafts of new standards, the GASB signaled an end to the simplified reporting that such entities had enjoyed. Net pension liabilities, pension expense amounts, and deferred outflows and inflows were to be calculated for such plans, and they were to be spread among, and reported in the financial statements of, participating employers in proportion to their respective "long-term contribution efforts." Year-to-year changes in the proportions were to be amortized over the expected remaining service lives of employees. An even greater potential challenge for cost-sharing plans and participating employers was the indication that the net pension liability figures included in the financial statements of participating employers would have to be measured at each employer's financial reporting date. This would have necessitated calculations of assets and liabilities at multiple dates for cost-sharing plans whose participating employers have different fiscal years.

The GASB received a great deal of feedback concerning the burdens that the reporting framework proposed for cost-sharing plans would impose on cost-sharing systems and participating employers. In response, it made significant changes to this framework in the final versions of the new standards.

- First, the requirement that values reported be measured as of the reporting date for each participating entity was significantly relaxed. The measurement date may precede the reporting date, provided that date is no earlier than the end of the employer's prior fiscal year and is consistently applied from period to period.
- Second, the basis for determining each participating employer's proportional share was changed from one based solely on long-term contribution efforts to one determined on a basis "consistent with the manner in which required contributions, excluding those that are projected to be made to the pension plan to separately finance amounts related to an individual employer, are determined." The use of long-term contribution efforts as part of this exercise is still encouraged, but not required.

Special Funding Situations

In establishing a new framework for pension accounting in the public sector, the GASB clarified the status of entities that contribute funds toward pensions of public sector employees but are not, strictly speaking, their employers. A commonly encountered example of such an arrangement is the funding of teachers' retirement systems, which in many states is the responsibility of the state and not of the school systems that employ the covered teachers. In some cases, the nonemployer entity has an obligation to contribute that is dependent on events or circumstances unrelated to the pension plan. Where this is the case, there is no need for the entity to include a share of the net pension liability, expense, or deferred inflows and outflows in its financial statements. However, where the obligation to contribute does not depend on external events, the nonemployer entity is required to account for its obligation to the pension plan as if it were a cost-sharing employer.

In Closing

The outcomes of the GASB's long deliberations over the revision of pension accounting in the public sector in the U.S. have been evident to a great degree since the publication of *Preliminary Views* in 2010. Nonetheless, most public retirement systems will face some challenges as they prepare to deal with the requirements of the new standards. Many, if not all, will find that they will require separate valuation reports to be prepared for financial-reporting and funding purposes, as is now common in the private sector, because the GASB's new mandated financial-reporting calculations will differ significantly from those performed to determine funding under state, local, and bargaining requirements.

The extensive substantiation of the assumed rate of return on fund assets and testing of the adequacy of expected future asset levels to cover projected benefits will require more extensive use of actuaries and investment professionals. For cost-sharing plans, a great deal of detail on the proportional shares of net pension liabilities, pension expense, and deferred inflows and outflows will be required, representing a significant increase in the volume of calculations required for such plans on an ongoing basis.

Buck Can Help

- Determine the possible implications of the new standards for retirement systems, employers, and nonemployer contributing entities
- Assess the likely magnitude of the amounts that will have to be reported under the revised requirements
- Assist plan sponsors and interested parties in weighing the facts and making the decisions that need to be made to develop a funding policy without the familiar annual required contribution from GASB 25
- Craft a communication approach to address the questions that inevitably will arise when the more significant liability disclosures, more volatile expense, and differences between funding and expense come to light