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Public Sector Letter

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Gearing Up to Comply with GASB's New Accounting Standards for Public Sector Pension Plans and Sponsoring Employers

Concluding a process that began five years ago, in August 2012 the Governmental Accounting Standards Board (GASB) published new accounting and financial reporting standards for pension plans provided through state and local retirement systems and their sponsoring employers that GASB had approved in late June. GASB Statement 67, *Financial Reporting for Pension Plans*, which will apply to state and local pension plans established as trusts or similar arrangements, will replace GASB Statement 25 for fiscal years beginning after **June 15, 2013**. GASB Statement 68, *Accounting and Financial Reporting for Pensions by State and Local Governmental Employers*, which will apply to governments that sponsor or contribute to state or local pension plans, will replace GASB Statements 27 and 50 for fiscal years beginning after **June 15, 2014**.[1]

Statements 67 and 68 establish standards for measuring and recognizing liabilities for accounting purposes, including the actuarial cost method, the discount rate and the amortization methods. In addition, they specify financial statement note disclosure and required supplementary information. This *Public Sector Letter* summarizes the key components of the new standards, which make significant changes to pension accounting and financial reporting for pension plans and for state and local governments that sponsor pension plans.[2] The *Public Sector Letter* concludes with a discussion of the implications of the new accounting standards for sponsors of state and local government plans.

GASB's New Accounting Standards Differ by Plan Type

In applying governmental accounting and financial reporting standards, GASB makes distinctions among different types of pension plans and their participating employers:

- *Single-employer pension plans* provide pensions to the employees of only one employer.
- *Agent multiple-employer pension plans* provide pensions to employees of multiple employers. The plan assets are pooled for investment purposes but separate accounts are maintained for each individual employer so that each employer's share of the pooled assets is legally available to pay the benefits of only its employees.
- *Cost-sharing multiple-employer pension plans* provide pensions to employees of multiple employers. The pension obligations for all employees are pooled and plan assets can be used to pay the benefits of the employees of any employer that provides pensions through the pension plan.

IN THIS ISSUE:

- GASB's New Accounting Standards Differ by Plan Type
- Divorce of Pension Accounting from Funding Measures
- Introduction of a New Measurement: Net Pension Liability
- Discount Rate for Calculating Total Pension Liability
- Recognition of Pension Expense by Employers
- Cost-Sharing Employers
- Measurement Timing and Frequency
- Implications

Divorce of Pension Accounting from Funding Measures

Unlike GASB's current accounting standards, which provide for a close link between pension accounting and funding measures, the new accounting standards have divorced financial reporting from any contribution requirements. Under the current standards, the annual required contribution (ARC) is essentially the accounting expense, and serves as a *de facto* funding standard for many plans because one of the disclosures is a historical comparison of the actual contribution made to the ARC. GASB does not — and never did — establish funding standards for public pension plans, and the new accounting standards make that clear by formally divorcing accounting from funding.

In many cases, the new standards do provide for a disclosure similar to the old ARC, but do not require it. *For single and agent employers and for the pension plans of single and cost-sharing employers,* if an actuarially

[1] If practical, employers are required to restate prior financial statements. Otherwise, employers should reflect the cumulative effect of the new accounting standards in the financial statements as a restatement of beginning net position. Both Statements and related information, including fact sheets that GASB released in October, can be accessed from the following page of GASB's website: http://www.gasb.org/cs/ContentServer?site=GASB&c=Page&pagename=GASB%2FPage%2FGASBSectionPage&cid=1176158721844

[2] Readers familiar with the Exposure Drafts issued by GASB in 2011 will find that the final statements generally follow the provisions of Exposure Drafts. GASB has made compliance somewhat easier in some areas including more flexible measurement dates and delayed effective dates.

determined contribution (ADC)[3] is calculated, the required supplementary information will show comparison of the actual contributions made to the ADC. *For single, agent, and cost-sharing employers and for the pension plans of single and cost-sharing employers,* if an ADC is not calculated and the contributions are statutorily or contractually required, the required supplementary information will show comparison of the actual contributions made to the statutory or contractually required contribution. The comparison of actual contributions to the ADC or the statutory/contractual contributions is not required for cost-sharing multiple-employer pension plans or their contributing employers.[4]

The optional nature of reporting the ADC comparison to actual contributions further emphasizes GASB's intentional divorce of funding from accounting.

Single and agent employers whose pension plans do not determine an ADC should consider a review of their funding policy in order to develop an ADC.

Introduction of a New Measurement: Net Pension Liability

For single and agent employers, the balance sheet in the basic financial statements will include a measure of the unfunded (or overfunded) pension obligation, called the net pension liability (NPL).[5] The new NPL is equal to the total pension liability (TPL) minus the plan's fiduciary net position (GASB's term for the market value of plan assets). *Single and cost-sharing pension plans* will report the components of the NPL in the notes to the pension plans' financial statements. The NPL should be measured as of a date no earlier than the end of the employer's prior fiscal year.

The TPL is the portion of the actuarial value of projected benefit payments that is attributed to past periods of service. Those projected benefits include projected salary increases, projected service, automatic cost-of-living adjustments (COLAs), and *ad hoc* COLAs to the extent that they are considered substantively automatic. All plans are required to use the entry age actuarial cost allocation method to determine the total liability as of the reporting period: projected benefits are discounted to their present value as of employees' hire ages and then attributed to employees' expected periods of employment as a level percentage of projected payroll. Many states and local pension plans already use the entry age actuarial cost method for funding purposes, along with a discount rate based on the long-term expected rate of return on plan investments. The TPL is based on a discount rate that may be based in part on a municipal bond rate. The derivation of the discount rate is described in detail in the next section.

Discount Rate for Calculating Total Pension Liability

If current and expected future plan assets (related to benefits for *current* plan participants) are insufficient to cover future benefit payments for current employees and retirees, the new basis for discounting projected benefit payments to their present value would require using a "blended" discount rate.

The long-term expected rate of return can be used to discount only those projected benefits that are covered by projected assets. Any projected benefits that are not covered by projected assets would be discounted using a yield or index rate for 20-year tax-exempt municipal bonds with an average rating of AA/Aa or higher. The blended discount rate, which GASB calls the single discount rate, is determined as follows:

- Project annual future benefit payments for current employees, inactive employees and retirees.
- Project the annual value of plan assets including current assets, projected employer and employee contributions, and investment earnings. Note that any projected contributions intended to finance the service cost of future employees are excluded. Projected contributions from future employees are also excluded unless those contributions are projected to exceed the service costs for those employees.
- Discount projected benefits using the long-term expected rate of return to the extent that the projected assets exceed the projected benefit payments.
- Discount all other projected benefits using the municipal bond rate.
- Determine the single discount rate that, when applied to all projected benefits, equals the sum of the two present values using the long-term expected rate of return and the municipal bond rate.

Note that if contributions are established by contract or statute or if a written funding policy related to employer contributions exists, professional judgment should be applied to project employer contributions based on those contractual, statutory or policy provisions. Professional judgment should consider the most recent five-

[3] The ADC is defined as follows:

> A target or recommended contribution to a defined benefit pension plan for the reporting period, determined in conformity with the Actuarial Standards of Practice based on the most recent measurement available when the contribution for the reporting period was adopted.

[4] A large table that summarizes the disclosure requirements introduced by Statements 67 and 68 is available as an online supplement to this *Public Sector Letter*. See the following page of The Segal Company's website: http://www.segalco.com/publications/publicsectorletters/dec12supp.pdf

[5] Under current accounting rules, the only balance sheet pension liability is the "Net Pension Obligation" which is the cumulative difference (if any) between the ARC and the actual contributions. This meant that employers who consistently contributed the ARC amount showed no pension liability on their balance sheets.

year contribution history and should reflect all known conditions. Otherwise, the projected contributions are limited to the average of the most recent five-year period, although this may be modified based on consideration of subsequent events. This is another reason employers should consider establishing a funding policy if one does not currently exist.[6]

Recognition of Pension Expense by Employers

For single and agent employers, pension expense in the current reporting period is based on changes in the NPL during the period. Most annual changes in NPL are immediately recognized as pension expense when they occur. These changes include the following (a plus sign indicating that a change is an increase in the NPL and so is an addition to pension expense, while a minus sign indicates the change is a decrease in the NPL and so is a subtraction from pension expense):

- Service cost (*i.e.*, normal cost under the entry age actuarial cost method (+),
- Interest on the TPL (+),
- Projected (*i.e.*, expected) earnings on the plan's investments (–),
- Actual member contributions (–),
- Administrative expenses (+), and
- Changes in TPL due to changes in benefit provisions (+ or –).

Other changes in the NPL are included in pension expense over the current and future periods. These changes include:

- Changes in TPL due to assumption changes or gains and losses are recognized over a closed period equal to the average of the expected remaining service lives of *all* employees that are provided with benefits through the pension plan, including active employees, inactive employees, and retirees, and
- Differences between assumed and actual investment returns on pension plan assets are recognized as pension expense over a closed five-year period.

The requirements discussed above apply to *employers* that sponsor pension plans. Pension *plans* do not recognize pension expense. However, pension plans must disclose a schedule of changes in the NPL, which will include most of the above items.

Cost-Sharing Employers

Under current GASB accounting standards, a cost-sharing employer's pension expense is its contractually required contribution to the cost-sharing pension plan. The balance sheet liability is the accumulated difference (if any) between the contractually required contribution and the actual contribution. The majority of cost-sharing employers contribute the contractually required contributions to the plan and therefore have no liability for pensions on their balance sheet.

- ***Net Pension Liability*** Under the new standards, an employer participating in a cost-sharing multiple-employer pension plan would report an NPL in its own financial statements based on its proportionate share of the collective NPL for the entire plan. The NPL for the entire plan is determined using the methods described above for single and agent employers. An individual employer's proportionate share of the collective NPL is determined using a method that is consistent with how the cost-sharing plan determines the contributions for the cost-sharing employers. A method that is based on the employer's projected long-term contributions to the pension plan as compared to the total projected long-term contributions of all employers is encouraged. The method could be based on the individual employer's share of the total employer contributions, payroll, or the method used by the cost-sharing plan to determine employer contribution.
- ***Pension Expense*** Consistent with reporting NPL, a cost-sharing employer's pension expense will be its proportionate share of the collective pension expense for the entire plan. In addition, if there is a change in the employer's proportion of the collective NPL since the prior measurement date, the net effect of that change is recognized in pension expense over the remaining service lives of all employees, inactive employees, and retirees. Similarly, the annual difference between an employer's actual contributions and its proportionate share of total contributions is recognized in pension expense over the remaining service lives of all employees, inactive employees, and retirees.

Special Funding Situations

The new accounting standards address special funding situations, when an entity (called a nonemployer contributing entity) that does not employ plan participants is legally responsible for making contributions directly to the pension plan. An example of a special funding situation is when the state pays a portion of the contribution for the school district. The nonemployer contributing entity must recognize an NPL and expense by applying the cost-sharing measurement described just above to the collective NPL and expense. The employer then recognizes a reduction in NPL and expense equal to the nonemployer contributing entity's proportionate share of the collective NPL and expense.

[6] For more information on establishing a successful funding policy, see The Segal Company's November 2011 *Public Sector Letter*: http://www.segalco.com/publications/publicsectorletters/nov2011.pdf

"GASB's new accounting standards substantially redefine pension expense and move funded status information to the balance sheet. These changes may have significant consequences for state and local governments."

Measurement Timing and Frequency

The measurement date of the NPL is as of a date no earlier than the end of the employer's prior fiscal year. Plan assets must be determined as of the measurement date. Actuarial valuations that determine the TPL must be performed at least every two years, although more frequent valuations are encouraged. The TPL as of the measurement date is determined either by:

- An actuarial valuation as of the measurement date, or
- Use of update procedures to roll forward from an actuarial valuation performed as of a date not more than 30 months plus one day prior to the current fiscal year end.

Implications

As noted, current GASB standards base pension expense on the ARC, which requires amortization of the unfunded liability over a period no greater than 30 years. In addition, funded status information does not appear in the financial statements, but does appear in the footnotes. GASB's new accounting standards substantially redefine pension expense and move funded status information to the balance sheet. These changes may have significant consequences for state and local governments:

- Reporting the NPL on the entity's financial statements (rather than reporting the historical difference between actual contributions and the ARC) will change the focus of the statements from the entity's long-term commitment to fund its obligation to a short-term emphasis on the funded status snapshot in time.
- Immediate recognition of changes in liability due to plan amendments and accelerated recognition of changes in liability due to actuarial gains and losses and changes in actuarial assumptions will result in a pension expense very different from the contribution amounts and will likely cause confusion between pension expense and pension funding. In addition, this heavy emphasis on immediate recognition of liability changes may result in policymakers choosing short-term expediency rather than the long-term impact of their decisions.
- It will be natural for stakeholders to compare the NPL to the unfunded actuarial accrued liability and pension expense to contribution requirements even though one set of numbers is for accounting purposes and the other is for funding purposes. This comparison will cause concern and confusion. It will be important for entities to communicate with stakeholders about the purpose of each measurement.

This confusion may lead to certain parties using the results for political and personal ends rather than focusing on the goals and objectives that are the reasons that the retirement systems were first created. This may lead to unintended consequences for taxpayers, plan participants and the users of government services.

For all the above reasons, retirement plans and the sponsors of these plans should establish or revisit existing funding policies to assure that they support long-term funding commitments, provide intergenerational equity and are transparent to stakeholders.

For more information about GASB's new pension accounting standards or assistance in working with auditors to comply with those standards, contact your Segal Company benefits consultant or one of the following experts:

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