A Look at the GASB's Preliminary Views on *Pension Accounting and Financial Reporting by Employers*

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Today's Webinar Will Cover

- Introduction
- Background on the GASB Process
- Highlights of Preliminary Views and Underlying Principles
- Separation of Accounting from Funding
- Liability on the Balance Sheet
- Measurement of Net Pension Liability
  - Cost Method
  - Discount Rate
  - Timing
- Pension Expense
  - Recognition of Investment Gains and Losses
  - Amortization of Changes in Liabilities
- Questions and Answers
- Instructions for EA Certificate of Attendance

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Introduction

- Role of the Governmental Accounting Standards Board (GASB)
- Nature of a Preliminary Views (PV) document
- This PV covers pension recognition for employers only
  - Balance sheet and income statement, but no notes or supplementary disclosures covered by PV
  - Plan accounting not addressed
  - OPEB not addressed
- Financial economics advocates' perspective
- Status quo advocates' perspective
- Significant changes in pension accounting

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Background on the GASB Process

- Research Project added to agenda January 2006
- Invitation to Comment Issued March 31, 2009
  - Written comments submitted by July 31, 2009
  - Public hearings held August 2009
- Preliminary Views Issued June 16, 2010
  - Only covers pension recognition issues. Views on note disclosures and supplementary information are forthcoming.
  - Views expressed conceptually. **Many details to be determined.**
  - Comments due September 17, 2010
  - Public hearings October 13, 14, and 27
- Next Step is an Exposure Draft, estimated for June 2011

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Highlights of the Preliminary Views

- Separates accounting from funding and adds volatility
- Recognizes net pension liability on the balance sheet (including cost sharing employers)
- Discount rate = blend of expected return and municipal bond index depending on sufficiency of projected assets
- Amortization periods are shorter (in some cases immediate recognition is required)
- Immediate recognition of accumulated investment gains and losses in excess of 15% of assets
- Maximum delay between measurement and disclosure has been reduced substantially

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Underlying Principles Driving the PV

- Grounded in GASB Concept Statement Nos. 1, 3 and 4
  - objectives of financial statements
  - accountability,
  - decision-usefulness,
  - assessment of inter-period equity,
  - cost of services,
  - characteristics of financial statements,
  - comparability,
  - definition of a liability,
  - sufficiently reliable measurement
- The GASB's activities confined to accounting (not funding)

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Underlying Principles Driving the PV (Continued)

- Long-term nature of governments
- Pension benefits are part of an employment exchange
- Economic and legal relationships among employer, plan and employee
- Plans and employers are primary and secondary obligors
- Balance sheet drives income/expense
- Recognition reflects the expected cost of services measurement
- Cost of pensions is recognized over working career

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Separation of Accounting from Funding

- GASB 25/27 Annual Required Contribution (ARC) has become a de facto national funding standard
  - Within parameters → viewed as "responsible funding strategy"
  - Outside parameters → viewed as ???
- Preliminary Views
  - Not appropriate for the GASB to set funding standards
  - Preliminary views are for accounting and financial reporting only
  - Changes in pension accounting rules do not require a change to contribution strategy
  - Volatility in accounting does not need to cause volatility in contributions

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Liability on the Balance Sheet

- In the PV, the balance sheet drives the income/expense
  - In the current model, income/expense drives the balance sheet
  - This is a significant change, and part of a larger trend

- Employer liability
  - Employer-employee exchange creates an obligation
  - Concept 4 definition of a financial statement liability
  - Pension fund is the primary obligor
  - Employer is secondary obligor while there are pension plan net assets;
  - Employer is the primary obligor to the extent that there are no plan net assets remaining

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Liability on the Balance Sheet

- Current balance sheet liability is the Net Pension Obligation (NPO)
  - NPO is the accumulation of differences between the annual pension cost (expense) and the actual employer contributions
  - Cost sharing employers have no balance sheet liability unless they are delinquent in paying the contractually required contributions
- Preliminary Views would require all employers to disclose an unfunded actuarial liability on their balance sheet as the Net Pension Liability (NPL)
- Cost sharing employers would be allocated a portion of their plan's NPL to recognize on their balance sheet

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Measurement of NPL – Attribution (Cost) Method

- Individual entry age normal actuarial cost method, with level percent of pay
- "… the employment relationship is an ongoing series of exchanges within the context of an employee's career with the employer." [PV page 22]
- "… the value assigned to the pension benefits exchanged for services each year over an employee's career should bear a consistent relationship to the employee's base salary level." [PV page 22]
- Expected cost of services (Concept Statement No. 1)
- Attribution pattern exhibited by entry age normal was considered most consistent with these views

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Measurement of NPL – Discount Rate

- “The discount rate should be the single rate that, when applied to projected benefit payments, results in a present value of those payments equivalent to the sum of

  (1) the present value of projected benefits expected to be paid from current and expected future plan net assets, discounted at the long-term expected rate of return on plan investments, and

  (2) the present value of projected benefit payments that are expected to be made after plan net assets are projected to be fully depleted, discounted using a high-quality municipal bond index rate.” [PV page 16]

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Measurement of NPL – Discount Rate (continued)

- Projected date of depletion is determined by:
  - Starting with the current market value of plan net assets
  - Projecting future employee contributions for current plan members
  - Projecting future employer contributions for current plan members based on the stated employer contribution policy and the recent pattern of actual employer contributions – *not clear how a future employer contribution for current plan members is defined*
  - Projecting future benefit payments for current plan members, (including future salary, service and other increases) and future administrative expenses
  - Projecting assets using a reasonable long-term expected rate of return
  - Similar to modeling a closed plan using a deterministic rate of return

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Measurement of NPL – Discount Rate (continued)

- For benefits expected to be paid *before* a projected date of depletion, ". . . the Board believes that the present value of the employer's projected sacrifice of resources is effectively modified (reduced) by the expected return on investment." [PV page 17]
  - Plan is the primary obligor
  - Reasonable long-term expected rate of return of the pension fund
  - Expected cost of services (cost to taxpayers)
- For benefits expected to be paid *after* a projected date of depletion, ". . . the discount rate should be . . . based on an index rate for governmental bonds of a high quality commensurate with the quality of the pension promise." [PV page 19]
- The GASB considered and rejected: a default-free rate and the government's own borrowing rate

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Measurement of NPL – Discount Rate (continued)

- A single discount rate will be used for calculating the balance sheet liability and service (normal) cost.
- Depending on whether or when there will be a projected asset depletion date, that single rate will be either:
  - A reasonable long-term expected rate of return on pension fund,
  - A high-quality government borrowing index rate, or
  - A blend of the two – a single equivalent rate.

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Measurement of NPL – Timing

- NPL is based on the latest available measurement of liabilities (but not more than 24 months prior to fiscal year end) projected to the fiscal year end reflecting all significant changes in the interim
  - Example: For a plan with annual valuations as of June 30 and an employer with a fiscal year end of June 30
  - The NPL as of June 30, 2015, would be based on liabilities from the June 30, 2014, actuarial valuation projected to June 30, 2015
  - While the June 30, 2013, valuation is within 24 months, it is not the latest available as of the fiscal year end
- NPL is based on the market value of assets at the end of the fiscal year
- In contrast, current disclosures could be based on a measurement as much as 48 months prior to the fiscal year end. Most employers, however, disclose more recent information, but not as current as the PV would require.

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Measurement of NPL – Implications

- NPL = Entry age accrued liability at blended discount rate less market value of assets
- Cannot determine the NPL prior to the fiscal year end
- The NPL will be significantly more volatile than what is currently disclosed as the UAAL for most plans
  - Market value of assets instead of smoothed value of assets
  - Discount rate is more likely to decrease (increasing liabilities) when assets decrease
- Some employers will have to change from their current actuarial cost method to EAN for accounting purposes
- Reported NPL will be current as of the end of the fiscal year

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Pension Expense

- Under current practice the annual required contribution (ARC) is calculated using any one of six actuarial cost methods and is the sum of:
  - Normal cost and
  - Amortization of the chosen method's unfunded actuarial liability:
    - Over a period not exceeding 30 years
    - Closed or open amortization
    - Level dollar or level percent of payroll
- Under current practice, the pension expense is calculated as:
  - The ARC, plus
  - Interest on the net pension obligation (previous year's balance sheet liability), plus
  - Adjustment to the ARC

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Pension Expense

- Under PV, the change in the Net Pension Liability from one year to the next is made up of:
  - the pension expense,
  - changes in deferred inflows/outflows, and
  - actual contributions

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Pension Expense

- The pension expense would be computed as:
  - Entry age normal service cost, <u>plus</u>
  - Interest on the entry age actuarial liability, <u>minus</u>
  - Expected return on plan net assets, <u>plus</u>
  - Recognition of cumulative unrecognized investment gains or losses outside the 15% corridor, <u>plus</u>
  - Amortized amounts of changes in the entry age normal actuarial liability due to:
    - liability (gains) / losses
    - changes in plan terms affecting past periods and
    - changes in actuarial assumptions
- Cost sharing employers would be allocated a portion of what the pension expense would be for the plan as a whole

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Recognition of Investment Gains and Losses

- Under the PV, investment gains / losses would be deferred until the accumulated difference between expected and actual exceeds 15% of the market value of plan net assets
  - While within 15% corridor, pension expense will be slightly less volatile than under current practice
  - When 15% corridor is exceeded, entire amount of the excess must be recognized in expense, potentially causing extreme volatility in pension expense

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Recognition of Investment Gains and Losses

- Table shows a very simplified example
  - Expected rate of return = 8%
  - Actual rate of return = -20%
  - No prior gains or losses
  - Contributions = benefit payments
- Corridor is determined at FYE
- For a typical plan with assets equal to 5x payroll, the immediate recognition in this example would represent 80% of payroll

Assets, beginning of year	$1,000
Expected Return	$80
Actual Return	($200)
Assets, end of year	$800
(Gain) / Loss	$280
15% Corridor	$120
Immediate Recognition	$160

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Amortized Recognition of Changes in Liabilities

- Under PV, changes in the entry age accrued liability are amortized as follows:
  - For changes related to active employees, the amortization period should be a weighted average of the expected service life of the group of employees affected (expected to be about 5 to 15 years)
  - For changes related to inactive employees, changes are recognized in pension expense immediately
  - PV is not specific, but may be moving toward a straight line amortization similar to FASB rules for private sector companies
    - Interest cost component of pension expense already captures interest on the amount being amortized, on a declining balance.
    - No more level dollar or level percent of pay amortization
    - All closed and layered amortization bases

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Amortization Example

	Actives	Inactives	Total
Expected Total Pension Liability	$ 500	$ 500	$ 1,000
Liability Gain / Loss	5	5	10
Assumption Changes	25	25	50
Benefit Changes	50	50	100
Total Pension Liability	$ 580	$ 580	$ 1,160
Ave Remaining Svc Life	10		
Amortization Charge	$ 8	$ 80	$ 88
Deferred Amount	$ 72	$ 0	$ 72

- Assumes FASB-type amortization method
- A benefit change affecting a specific group of employees would be amortized over that group of employees' average expected remaining service life

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Questions and Answers?

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