SEGAL Bulletin

Benefits, Compensation and HR Consulting

July 2010

GASB's Preliminary Views on Proposed Changes to Pension Accounting Standards for Public Sector Employers

The Governmental Accounting Standards Board (GASB) recently issued Preliminary Views on major issues related to *Pension Accounting and Financial Reporting by Employers*.[1] This Preliminary Views is a step toward an Exposure Draft targeted for release in 2011 and, eventually, a new Statement of Government Accounting Standards that would replace the standards in the current Statement 27. This *Bulletin* summarizes the key proposals in the Preliminary Views, which would make fundamental changes to pension accounting standards for state and local governments.

PRELIMINARY VIEWS

GASB seeks comments on the following preliminary views:

- ***Reporting Pension Liability*** The unfunded portion of the pension obligation would be reported as a net pension liability[2] (total liability minus the value of plan net assets) on the balance sheet portion of the employer's financial statements. This would be a significant change from the current practice of reporting pension liabilities in the notes that supplement pension plans' financial statements.

- ***Projections*** GASB is proposing that the net pension liability should be based on projections that include future service and salary increases. Some pension plans have cost of living adjustments (COLAs) that adjust benefits for inflation. COLAs can be either automatic or ad hoc. If an employer's past practice of granting ad hoc COLAs indicates that they effectively have become automatic, they would have to included in benefit projections.

- ***Discounting*** The basis for discounting projected benefit payments to their present value would continue to be a reasonable long-term expected rate of return on the plan's investments, *but only to the extent that the current and expected future plan assets will be sufficient to cover the future benefit payments*. Benefit payments that are expected to occur beyond the point that expected plan assets are projected to be exhausted would be discounted to their present value using a high-quality municipal bond index rate. In practice, these two discount rates would be combined into a single, weighted average rate. Note that the new discount rate would be based on a comparison of projected assets to projected benefit payments, and not simply on the plan's current funded status. This change should only affect plans that are receiving contributions that are less than their actuarially determined contribution requirement.

- ***Cost-allocation Method*** GASB is proposing that all plans use the same cost 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. This "entry age" method is already used by most plans. Plans that use the other most common cost method — "projected unit credit" — most likely would see an increase in their accrued liability.

- ***Annual Changes in Total Pension Liability*** Changes in liability due to new pension benefits earned by employees and the interest cost on the beginning balance of the total pension liability would be reported as expenses each year as they occur. This is generally consistent with current practice except perhaps for plans using longer amortization periods.

- ***Amortization Period for Other Changes in Total Pension Liability*** Three types of changes in the total pension liability would be reported as expense over a

---

[1] The Preliminary Views is available on the following page of GASB's Web site: http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176156938122

[2] "Net pension liability" is a new term introduced in this Preliminary Views. It essentially means the unfunded actuarial accrued liability using the market value of assets.

period representative of the remaining service periods of employees: differences between expected and actual experience ("gains and losses"), changes in assumptions about future experience, and changes in pension plan terms that affect benefits for past service. For such changes in liability for active participants, this expensing approach is much shorter than the current practice which allows recognition over a period up to 30 years. Corresponding changes in liability for retirees would be expensed *immediately*, which is a *dramatic* departure from current practice.

- ***Effect of Investment Return*** Differences between assumed and actual returns on pension plan assets would be deferred as long as the accumulated amount deferred does not exceed 15 percent of the fair value of plan assets. Any accumulated deferrals that exceed 15 percent of the plan assets would be reported immediately as an expense (or a reduction in expense) in the current year. This differs substantially from current practice where such deferred amounts are recognized in the unfunded liability over a short period, but then are amortized for expense purposes.

- ***Cost-sharing Employers' Liability*** An employer participating in a cost-sharing multiple employer pension plan would report an unfunded liability in its own financial statements based on its proportionate share of the collective unfunded liability for the entire plan. Currently, these employers do not report an unfunded liability, not even in their footnotes or schedules.

- ***Calculation Date*** The net pension liability would be measured at the end of an employer's fiscal year. An actuarial valuation would need to be performed at least once every two years. Although the valuation date would not need to be the employer's fiscal year-end, it would need to be a date no more than 24 months earlier. This would require each plan to project their pension obligation to the fiscal year-end, including any interim changes since the valuation date that affect the net pension liability.

IMPLICATIONS

If GASB incorporates the proposals outlined in its Preliminary Views into a final accounting standard, the consequences for state and local governments would be significant, including the following:

- Reporting the entire unfunded liability on the basic financial statements (rather than just any unfunded annual required contributions or "ARC") changes the focus of the statements from the entity's commitment to fund its obligation to a snapshot in time. This would make the statements less transparent regarding whether a government is actually following a responsible funding plan.

- A significant proposed revision is how three types of changes in unfunded liability — actuarial gains and losses, plan amendments and changes in actuarial assumptions — are deferred or amortized. This would change the meaning of pension expense and would create difficulties in understanding the new relationship between pension expense and pension funding. That is because the current expense requirement — the ARC noted above — serves as a standard for responsible funding.

- The prior point leads to the third major change, which is not given much discussion in the Preliminary Views, but may be the most important: de-linking pension expense (the ARC) and pension funding. Under current GASB rules, the ARC serves as a *de facto* contribution standard. The creation of two different sets of "cost" numbers (a funding calculation determined by the plan that would remain fundamentally unchanged and a separate pension expense number) could have an unintended, detrimental effect on public attitudes about state and local government pension plans. At a minimum, it would cause confusion about which is the "true" cost.

The proposed changes would have other implications. For example, the proposed change in how investment earnings are recognized will create less expense volatility in some situations and greater expense volatility in others.

GASB is accepting comments on the Preliminary Views until September 17, 2010. The Segal Company will submit comments that will be shared with clients.[3] Segal encourages state and local governments to prepare their own comments to GASB.

■ ■ ■

The Segal Company can be retained to work with employers, plan sponsors and their auditors in their efforts to determine the potential impact of the requirements in GASB's Preliminary Views on their plans and practices.

[3] Segal's comments to GASB will also be accessible from the Hot Topics and What's New pages of Segal's Web site.

SEGAL

To receive future Segal Company *Bulletins* and other publications as soon as they are available online, register your e-mail address via Segal's Web site: www.segalco.com/register/

For a list of Segal's 21 offices, visit www.segalco.com/about-us/contact-us-locations/

www.segalco.com