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## Taking a Second Look: A New Approach to Postemployment Benefits

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## *New Pension Accounting Standards*

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- ◆ Remember the tag line from the JAWS movie?

*“Just when you thought it was safe to go back in the water . . . .”*

- ◆ Now that we all have gotten used to the Pension and OPEB accounting standards . . .



## *New Pension Accounting Standards*

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- ◆ GASB will issue a Preliminary Views document that presents their current thinking on new pension accounting standards
  - ▶ By the end of June
  - ▶ It's not your father's Oldsmobile
  - ▶ It contains some things you won't like
  - ▶ Some things you will like
  - ▶ It does not contain some things that you'll be glad about
- ◆ Michelle Czerkawski (GASB Staff) will provide details



# *The Great Debate*

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- ◆ Recent articles and papers

- ▶ New York Times, Wall Street Journal and dozen of others
- ▶ Stanford, Northwestern, Manhattan Institute
- ▶ Society of Actuaries

- ◆ Caution. Read with discernment. Separate:

- ▶ Governance issues from
- ▶ Measurement issues



# *The Great Debate*

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## ◆ Governance issues include:

- ▶ Failure to pay an actuarially determined contribution
- ▶ Failure to consider long term sustainability before adopting benefit improvements
- ▶ Failure to consider short term investment volatility before adopting benefit improvements



# *The Great Debate*

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## ◆ Measurement issues include:

- ▶ Selection of the attribution method to allocate costs to years of service
- ▶ Whether to project future increases in pay, service, etc.
- ▶ And the most controversial –  
Selection of appropriate interest discount rate

# The Great Debate





# *The Great Debate*

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- ◆ The measurement debate is all about:

**Measurement Attributes**

**And**

**Valuation Premise**

**Market Value of the Liability (MVL)**  
versus  
**Actuarial Methods**

**Daily Market Price of the Liability**  
Versus  
**Cost of Services Over Time**



# *The Market Value of a Pension Liability*

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- ◆ There are two core features of MVL:
  - ▶ The right attribution pattern is based on benefits earned to date – the Accumulated Benefit Obligation (like FASB)
  - ▶ The right discount rate is derived from a default-free yield curve observed in the market as of the reporting date



# The Market Value of a Pension Liability

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- ◆ Here are the principles for how they get there:
  - ▶ Step 1 – The measurement attribute for all government assets and liabilities should be *fair market value*, re-measured at each reporting date
  - ▶ Step 2 – The pension plan/fund is merely a *pass-through*

Corollary to Step 2 – The employer has an obligation (first dollar) to pay benefits to the employee, not contributions to the plan/fund. The employer's liability is for all benefits earned to date.



# The Market Value of a Pension Liability

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- ◆ Here are the principles for how they get there:
  - ▶ Step 3 – The earned pension benefit stream is *bond-like*
  - ▶ Step 4 – A fair value considers the *default characteristics* of the promise
  - ▶ Step 5 – Government sector pension promises are essentially *default free* with respect to benefits earned to date



# *The Market Value of a Pension Liability*

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- ◆ That's how they get to these two core features of MVL
  - ▶ The right attribution pattern is based on benefits earned to date – the Accumulated Benefit Obligation (like FASB)
  - ▶ The right discount rate is derived from the default-free yield curve observed in the market as of the reporting date
- ◆ And a third:
  - ▶ All changes in the market values of pension assets and pension liabilities should be recognized immediately



# *Actuarial Valuation Methods*

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- ◆ Actuarial Methods have a entirely different worldview.
- ◆ Government sector pension liabilities are:
  - ▶ Not merely negative assets held for sale or exchange
  - ▶ Held as in-service liabilities to maintain a workforce
  - ▶ Seldom ever settled all at once in a market transaction



# *Actuarial Valuation Methods*

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- ◆ Measurement methods should reflect the cost of services to taxpayers over time
- ▶ The right attribution pattern should reflect an employee's cost of services as a level percent of pay over his or her career
- ▶ The right discount rate should incorporate the expected cost to taxpayers over time.



# *Price vs. Cost*

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## ◆ **FIVE TAKE-AWAYS –**

1. Look for governance issues separate from measurement issues in the press
2. The Great Debate is all about the most appropriate measurement attribute
3. Two distinct worldviews:  
Market Value of Liability and Actuarial Methods

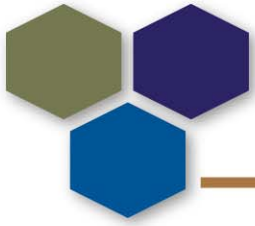


## *Price vs. Cost*

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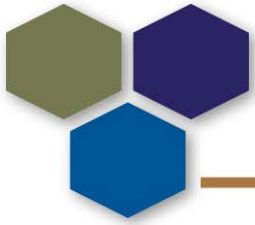
### ◆ **FIVE TAKE-AWAYS –**

4. The Market Value of Liability seeks to measure the fair value of the pension benefits earned to date, measured at a market price on the reporting date as if traded in a single sum settlement transaction in a hypothetical market
5. The Actuarial (Mainstream) Methods seek to measure the expected cost to taxpayers over time, based on service costs that are level as a percent of pay and based on expected future investment returns

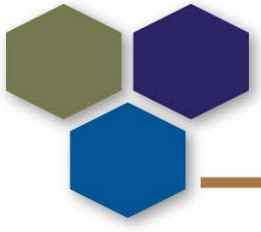


## Acknowledgement

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# GASB's project on postemployment benefits

Michelle Czerkowski, GASB staff

Monday, June 7, 2010

The views expressed in this presentation are those of the speaker. Official positions of the GASB are determined only after extensive due process and deliberation.

# Overview

- ▶ Why is the GASB looking at this topic?
- ▶ Overview of the preliminary views of the Board
- ▶ Next steps

# Why is the GASB looking at this topic?

- ▶ Procedural requirements
- ▶ What has changed since the issuance of current standards?
  - Concepts Statements No. 3 and No. 4
- ▶ What is the status of the Board's activities and how has it gotten there?
  - Research project
  - Current technical agenda project
    - Invitation to Comment
    - Deliberations
    - Preliminary Views

# Preliminary Views

- ▶ Due process document
- ▶ Tentative conclusions of the GASB
- ▶ When used?
  - Prior to Exposure Draft
    - Views of Board members are split
    - Views of constituents are expected to be split (this case)
- ▶ Scope of this document
  - Major issues related to employer accounting for pensions
  - Not included: plan reporting, note disclosures, OPEB

# Overview of the Preliminary Views of the Board

- ▶ Underlying principles
- ▶ Sole and agent employers
  - Liability recognition and measurement
  - Expense recognition
- ▶ Cost-sharing employers
- ▶ Timing and frequency of measurement

# Underlying principles

- ▶ Pension benefits are part of total compensation for employees' services
- ▶ Employment-exchange transactions create an obligation of employer to employees to provide pension benefits in retirement
  - Annual exchanges
  - Viewed by Board within context of an ongoing, career-long employment relationship
- ▶ An employer retains this obligation to its employees until benefits are paid

# Underlying principles (cont.)

- Primary and secondary responsibilities for the obligation
  - Employer primarily responsible for unfunded portion
  - Pension plan primarily responsible to the extent plan net assets have been accumulated
- Employer remains secondarily responsible for the funded portion of the pension obligation

# Sole and agent employers— liability recognition

- ▶ Unfunded obligation meets definition of a *liability* of the employer (GASBCS 4)
  - Present obligation
  - Requires sacrifice of employer's resources
  - Little or no discretion to avoid sacrifice of resources
- ▶ Unfunded obligation = *net pension liability*
- ▶ Liability meets criteria for recognition (GASBCS 3)
  - Measurable with sufficient reliability
  - Disclosure is not a substitute for recognition

# Sole and agent employers— liability measurement

- ▶ Projection of benefits
  - What is same?
    - Automatic COLAs
    - Projected future salary increases
    - Projected future service credits
  - What is different?
    - Ad hoc COLAs when substantively automatic
      - *Open question: Criteria*

# Sole and agent employers— liability measurement (cont.)

- ▶ Discount rate
  - Single rate reflecting
    - **Long-term expected rate of return** to extent that current and projected future plan net assets are expected to be available for pension benefits to current plan members
    - **High-quality municipal bond index rate** to extent that benefit payments for current plan members are not expected to be covered by plan net assets

# Sole and agent employers—liability measurement (cont.)

- ▶ Attribution of the present value of projected benefit payments to periods
  - Single method
  - Entry age actuarial cost method
  - Level percentage of payroll
  - Attribution period: expected service life of each employee
- ▶ Total liability = service costs attributed to past periods
- ▶ Net pension liability = Total liability less amount equal to plan net assets (including investments at fair value)

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability
  - Service cost
  - Interest on beginning total liability

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability
  - Service cost: **current-period expense**
  - Interest on beginning total liability: **current-period expense**

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability
  - Service cost: current-period expense
  - Interest on beginning total liability: current-period expense
  - Differences between actual and expected results
  - Changes in assumptions
  - Benefit changes

# Sole and agent employers— expense recognition

## ▶ Sources of changes in the net pension liability

- Service cost: current-period expense
- Interest on beginning total liability: current-period expense

- Differences between actual and expected results
- Changes in assumptions
- Benefit changes

To the extent they impact the total liability:

Defer and recognize expense over period(s) representative of each individual's expected remaining service life:

- Active and inactive groups treated separately
- Period for each group should be average expected remaining service life (weighted)

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability (cont.)
  - Changes in plan net assets available for pension benefits

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability (cont.)
  - Changes in plan net assets available for pension benefits
    - Expected investment returns

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability (cont.)
  - Changes in plan net assets available for pension benefits
    - Expected investment returns: **current-period expense**

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability (cont.)
  - Changes in plan net assets available for pension benefits
    - Expected investment returns: current-period expense
    - Differences between actual and expected investment returns

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability (cont.)
  - Changes in plan net assets available for pension benefits
    - Expected investment returns: current-period expense
    - Differences between actual and expected investment returns:
      - **Deferral of cumulative differences within 15% of the fair value of plan investments**
      - **Expense portion of cumulative deferrals outside the corridor**

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability (cont.)
  - Changes in plan net assets available for pension benefits
    - Expected investment returns: current-period expense
    - Differences between actual and expected investment returns
      - Deferral of cumulative differences within 15% of the fair value of plan investments
      - Expense portion of cumulative deferrals outside the corridor
    - Other changes

# Sole and agent employers— expense recognition

- ▶ Sources of changes in the net pension liability (cont.)
  - Changes in plan net assets available for pension benefits
    - Expected investment returns: **current-period expense**
    - Differences between actual and expected investment returns
      - Deferral of cumulative differences within 15% of the fair value of plan investments
      - Expense portion of cumulative deferrals outside the corridor
    - Other changes: **current-period expense**

# Cost-sharing employers

- ▶ Underlying principles
  - Employer obligations arise from employment exchanges with employees
  - Plan primarily responsible for collective obligation to extent of plan net assets
  - Employers (collectively) primarily responsible for unfunded collective obligation
    - Reflects sharing of benefit risks and pooling of assets in a cost-sharing plan

# Cost-sharing employers (cont.)

- ▶ Each employer is implicitly primarily responsible for a proportionate share of the collective unfunded pension obligation
  - Recognition of proportionate shares by employers
    - Meets definition of liability
    - Is measurable with sufficient reliability to support recognition
  - *Open question:* Allocation basis
- ▶ Proportionate recognition of collectively calculated pension expense and deferred outflows (inflows)
  - *Open question:* Treatment of changes in proportionate share

# Cost-sharing employers (cont.)

- ▶ Measurement approach
  - Single measurement at the collective level
  - Allocation of the results to individual employers for financial reporting purposes

# All employers—frequency and timing of measurements

- ▶ Net pension liability as of fiscal year–end
  - Total liability
    - Actuarial valuations at least every 2 years
      - Must be within 24 months of fiscal year–end
      - Update to financial report date
        - Must consider all significant events and transactions
  - Plan net assets measured at employer’s fiscal year–end

# Next steps

- ▶ Preliminary Views available on website ([www.gasb.org](http://www.gasb.org)) June 16, 2010
- ▶ Comment period
  - Ends September 17, 2010
  - Three public hearings scheduled
    - Dallas
    - San Francisco
    - New York
- ▶ Timeline for remaining issues
  - Additional employer reporting issues
  - Pension plan accounting and reporting
  - OPEB

# Wrap-up and questions