THE ACCOUNTING ANGLE

The GFOA Weighs in on Pensions

By Stephen J. Gauthier

At the end of March, the Governmental Accounting Standards Board (GASB) issued an Invitation to Comment (ITC) document on *Pension Accounting and Financial Reporting*. The ITC invited interested parties to comment on certain crucial aspects of accounting and financial reporting for pensions. On August 26, 2009, representatives of the Government Finance Officers Association (GFOA) testified at a public hearing on the ITC held by the GASB at its offices in Norwalk, Connecticut. That testimony was developed by two of the GFOA's standing committees (the Committee on Accounting, Auditing, and Financial Reporting, and the Committee on Retirement Benefits and Administration) and was delivered jointly by representatives of both committees. This article will examine the details of that testimony.

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APPROPRIATE FOCUS OF ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS

How an employer *incurs an obligation* to employees for pension benefits is one thing; how that same employer finances pension benefits can be quite another. Current GASB standards focus on whether an employer is meeting its actuarially determined funding requirements (financing focus). Private-sector pension guidance, on the other hand, focuses on the employer's obligation to its employees for benefits as of the reporting date (obligation focus). The GFOA has taken the following position:

> The ultimate cost of pension benefits is reduced by earnings on related investments. The rate of return on investments is much more predictable, of course, over the long term than over the short term. Consequently, a measure of pension cost that focuses on a single point in time (employer's obligation for benefits earned as of the reporting date) will likely be significantly more volatile than one that takes a longer-term perspective (obligation reflective of employer funding requirements).
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> There is no reason to believe that a given private-sector enterprise will still be in business next year, let alone 30 or 40 years from now. Consequently, a serious case can be made for adopting a point-in-time/termination focus for private-sector employers, despite the inherent volatility of such a measure. State and local governments, on the other hand, are perpetual entities for all practical purposes. That being the case, taking a point-in-time/termination perspective for the measurement of a long-term obligation that is highly susceptible to market fluctuations only serves to inject a needless element of volatility that significantly detracts from the usefulness of the informa-

> tion to decision makers and could easily lead to decisions that are detrimental to the best interests of all concerned (benefit increases in the wake of transient market gains).
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> Furthermore, the key issue for decision makers in the public sector regarding pension benefits is the sustainability of employer funding. A funding-focused approach provides information directly relevant to the assessment of sustainability, whereas an obligation-focused approach confuses the issue by highlighting temporary fluctuations that have little import on long-term funding requirements.
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> Accordingly, the GFOA strongly supports maintaining the current focus on employer funding requirements in accounting and financial reporting for pension benefits.

ISSUES RELATED TO LIABILITY RECOGNITION

Not every *obligation* constitutes a *liability* for accounting and financial reporting purposes. Today, for example, a state or local government employer does *not* display a *liability* on the face of the financial statements for the employer's unfunded accrued *obligation* to employees for benefits already earned. Conversely, employers are required to report a liability for the cumulative effect of any failure on their part to fully fund their annual required contributions to finance future benefit payments (consistent with a financing focus). An alternative would be for employers to report the entire unfunded accrued benefit obligation as a liability on the face of the financial statements, as in the private sector. The GFOA has taken the following position:

> We acknowledge that an argument can be made that the unfunded actuarial accrued liability for pension benefits meets the basic definition of an accounting liability set forth in GASB Concepts Statement No. 4, *Elements of Financial Statements*. However, GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, indicates that a potential element of a financial statement must also be "measurable with sufficient reliability" to qualify for display on the face of the financial statements (paragraph 34); otherwise, it should be disclosed instead in the notes to the financial statements (paragraph 35c). In our view, the unfunded actuarial accrued liability is *not* sufficiently measurable for display purposes, but is more appropriately presented as a note disclosure.
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> At the same time, we are persuaded that the accumulated underfunding of past required contributions both meets the basic definition of a liability *and* is reasonably measurable. We therefore support its continued presentation as a liability on the face of the statement of net assets.

ISSUES RELATED TO EXPENSE RECOGNITION

Under the accrual basis of accounting, the effect of transactions and events is normally recognized in the financial statements when they occur. However, in the case of pension accounting, the recognition of the effect of certain events and transactions may occur only gradually (i.e., amortization). For example, if the formula used to calculate benefit payments were to change in favor of future retirees (e.g., from 3 percent of salary x number of years worked to 4 percent of salary x number of years worked), the additional cost of this retroactive benefit enhancement could be amortized as expense over a period of up to 30 years, rather than recognized immediately as an expense of the period in which the change occurred. The same treatment applies to actuarial gains and losses (disparities between actuarial assumptions and actual outcomes). The GFOA has taken the following position:

> In our view, the deferral and amortization of actuarial gains and losses is logically consistent with the long-term focus inherent in a funding-based approach to measuring pension cost. The deferral and amortization of the cost of retroactive benefit enhancements, on the other hand, is a very different matter. We appreciate the concerns of those who question the logic of amortizing such costs over a lengthy period not clearly connected to any anticipated "future benefit" resulting from the enhancement. Accordingly, we would be open to the possibility of substantially limiting deferral and amortization to a period logically consistent with the anticipated future benefit of the enhancement (remaining service life of benefiting employees or contract term), or even to the possibility of eliminating deferral and amortization altogether for retroactive benefit enhancements.

> We are convinced that the principle of interperiod equity is best served when fluctuations unrelated to the value of the service performed by employees in a given period (actuarial gains and losses) are prevented from having an undue impact on the period in which they happen to occur (amortization versus immediate recognition of actuarial gains and losses).

APPROACHES TO MEASUREMENT

A pension formula typically applies *not* to today's salary levels, but to future salary levels upon the completion of service. Those future salary levels will typically reflect intervening events (e.g., cost-of-living adjustments and projected salary increases). Current GASB standards include such factors in the calculation of the employer's unfunded accrued benefit obligation for benefits *already earned*.

Furthermore, under current GASB standards, the calculation of the employer's *unfunded* accrued benefit obligation is reduced by anticipated earnings on amounts placed in trust. Currently, the appropriate discount rate used for this purpose is the pension plan's estimated long-term investment yield (rather than a more conservative and objective measure such as the risk-free rate of return, the employer's borrowing rate, or the average return on high-quality municipal bonds). The GFOA has taken the following position:

> It is our opinion that projected benefits should reflect all factors reasonably expected to affect the ultimate level of future benefit payments to employees because that amount constitutes the economic substance of the compensation arrangement, as understood by both the employer and the employee.
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> We continue to believe that the discount rate should reflect actual anticipated earnings based on the type and mix of investments that will be used to pay benefits. Using a risk-free rate or some similar unrealistically conservative measure would violate interperiod equity by artificially raising the amount of pension cost recognized in the current period. Just as the estimated useful life of a capital asset for purposes of depreciation should reflect the government's individual experience and circumstances rather than some abstract norm, so too, the discount rate used for pensions should reflect a particular government's earnings prospects in its specific circumstances.

ACTUARIAL METHODS

Deferral and amortization raise a number of practical issues — selection among actuarial methods, length of amortization period, level dollar versus level percentage of pay, closed (fixed period) versus open (rolling period), valuation of plan assets. The GFOA has taken the following position:

We believe that a genuinely funding-driven approach ought to be comprehensive enough to allow for the use of any acceptable actuarial cost allocation method applied in a manner consistent with professional actuarial standards. At the same time, we share the concerns of critics of open amortization. Indeed, we would be supportive of a change in standards that would prevent the amount to be amortized from actually increasing rather than decreasing.

ACCOUNTING BY EMPLOYERS IN COST-SHARING PLANS

Some employers participate in *cost-sharing* multiple employer plans, where employees from various employers are combined into a single pool. Under current standards, employers account for their participation in the pool much as they would account for insurance. An alternative would be for employers in cost-sharing plans to use the same accounting and financial reporting as employers in single-employer and multiple-employer agent plans, based on their proportionate share of the plan's assets and actuarial accrued liability. The GFOA takes the following position:

> We believe that a cost-sharing plan is similar in many ways to an investment pool or mutual fund. Just as it normally is not appropriate to attempt to "look through" a pool or mutual fund to its individual investments, so also we believe that it would be inappropriate to attempt to "look through" a cost-sharing pension plan to a participating employer's "share" of assets and liabilities. Those interested in more information on the cost-sharing arrangement should be referred to the plan's financial statements.

STEPHEN J. GAUTHIER is director of the GFOA'S Technical Services Center in Chicago, Illinois.