GASB Issues Exposure Drafts on Pensions

By Stephen J. Gauthier

In June, the Governmental Accounting Standards Board (GASB) issued two exposure drafts (ED) on accounting and financial reporting for pensions. One of these EDs focuses on employers; the other on pension plans. This article highlights the key proposals in each.

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PARTICIPANTS IN SOLE-EMPLOYER AND AGENT PLANS

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Employer Liability (Asset). Currently, an employer reports a liability (asset) only if there is a difference between 1) the employer's actuarially determined annual required contribution (ARC) and 2) actual contributions and benefit-related payments made by the employer. The ED proposes that an employer should report a net pension liability (or asset) for the difference between:

- The present value of projected benefits earned by employees for past service (*total pension liability*); and
- The plan's *net position* (i.e., [assets + deferred outflows] - [liabilities + deferred inflows] = *plan net position*) as of the employer's reporting date. For example, if the present value of the employer's total pension liability was $100, and plan net position was $90, the employer would report a net pension liability of $10. Conversely, if those amounts were reversed, the employer would report a $10 net pension asset.

Discount Rate. An employer's total pension liability represents the *present value* of projected benefits earned for past service. Currently, discounting is based on the estimated long-term investment yield for the plan, with consideration given to the nature and mix of current and expected plan investments. Some critics of current practice have argued that the use of an investment-based discount rate is inappropriate for any portion of the total pension liability that will not, in fact, be paid out of plan assets (i.e., because the plan is underfunded). Other critics object to the use of an investment-based discount rate in any circumstances, arguing instead for the use of a risk-free rate of return (e.g., U.S. Treasuries). The GASB rejected calls to mandate the use of a risk-free rate of return for discounting. The board agreed with critics, however, that the use of an investment-based discount rate was inappropriate for benefits not expected to be paid from current or future plan net position. Accordingly, the ED calls for the use of a single blended rate that reflects both:

- The long-term expected rate of return on plan investments to the

extent that current and expected future plan net assets available for pension benefits are projected to be sufficient to make benefit payments; and

- A high-quality tax-exempt municipal bond index rate for those payments that are projected to be made beyond the point at which plan net assets available for pension benefits are projected to be fully depleted.

Actuarial Method. Employers have always been free to choose among several different actuarial methods for funding purposes. Traditionally, accountants have used whatever method the employer selected for funding for financial reporting as well, provided that the method selected is applied in conformity with certain parameters established by the GASB. The ED proposes that all employers use a single actuarial method for accounting and financial reporting purposes, regardless of the method selected for funding, and that that method be the entry age actuarial cost method, with each employee's service costs being level as a percentage of that employee's projected pay.

Basic Approach to Measuring Pension Expense. Pension expense currently is calculated based on the employer's actuarially determined *annual required contribution*. The ED proposes that an employer's pension expense should reflect the composite effect of all changes in the employer's net pension liability not treated as deferred outflows or inflows of resources.

Deferral and Amortization. An employer's total pension liability may change because of:

- Changes in benefits;
- Changes in economic and demographic assumptions; and
- Differences between economic and demographic assumptions and actual experience.

Currently, the effect of changes and differences is amortized as pension expense over a period not to exceed 30 years. The ED proposes that the effect of these items be deferred and amortized over the remaining service lives of the individuals concerned (which in the case of inactive employees would mean immediate recognition). Likewise, any portion of a change in benefits attributable to past years of service (e.g., retroactive benefit enhancements) would be recognized as expense immediately.

Employers have always been free to choose among several different actuarial methods for funding purposes.

An employer's total pension liability also may change because of differences between the expected rate of return on plan investments and actual experience. Currently, the effect of such differences is amortized as pension expense over a period not to exceed 30 years. The ED proposes to amortize the effect of such differences over a five-year closed period.

PARTICIPANTS IN COST-SHARING PLANS

The GASB is also proposing significant changes in how employers in cost-sharing multiple-employer defined benefit plans account for the cost of pension benefits. Currently, employers in cost-sharing defined benefit pension plans recognize expense and liabilities based solely on their contractually required contributions to the plan. The ED proposes that each employer in a cost-sharing plan recognize its proportionate share of the collective net pension liability of all participating employers, as well as its proportionate share of the collective pension expense of all participating employers. The ED further proposes that:

- A participating employer's proportionate share of the total net pension liability and total pension expense be based on the employer's expected long-term contribution effort to the plan as a proportion of the expected contribution efforts of all participating employers; and
- The effect of a change in an individual employer's proportionate share of the collective net pension liability (including the effect of differences between the employer's actual and expected proportionate share) be deferred and amortized over a closed period representative of the average remaining service lives of employees.

SPECIAL FUNDING SITUATIONS

A special funding situation occurs when one entity (e.g., state) is legally required to make pension contributions on behalf of the employees of another entity (e.g., school district). The ED proposes the following guidance for such non-employer contributors.

- If the requirement to make the contribution is conditional on one

or more events or circumstances unrelated to the pension arrangement, the ED proposes that the contribution be treated as an on-behalf benefit payment in accordance with GASB Statement No. 24, *Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*; and

- If the requirement to contribute is unconditional, the ED proposes that the contributing entity use essentially the same accounting as participating employers.

PENSION PLANS

The GASB's other ED focuses on accounting and financial reporting by pension plans themselves. This ED proposes that pension plans make all of the changes needed for their accounting and financial reporting to remain compatible with the proposed new accounting and financial reporting for employers. Thus, for example, pension plans would be required to use the entry-age actuarial cost method for accounting and financial reporting purposes, regardless of the actuarial method used for funding purposes.

The ED also proposes that pension plans disclose in the notes to the financial statements both the actual time-weighted rate of return on their investments and the money-weighted rate of return. It also proposes to require that ten-year data for both be presented as required supplementary information (RSI).

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