GASB's New Pension Standards: Major Changes to Increase Transparency, Consistency and Comparability

By R. Kinney Poynter

Citizens and governing bodies are demanding more transparency regarding a government's overall financial condition and individual transactions than ever before. The movement toward more transparency began just before the economic downturn that emerged in 2008, but really gathered steam with the passage of the American Recovery and Reinvestment Act in 2009, which required quarterly reporting on a national website of Recovery Act-related expenditures. States and many local governments followed by creating their own transparency websites. In 2012, the Governmental Accounting Standards Board, known as GASB, issued two new accounting principles that are designed to provide increased transparency into one of government's largest unfunded liabilities—pension systems. GASB, through the issuance of Statement No. 67 for pension plans and Statement No. 68 for employers, has dramatically changed the way pensions are calculated and reported in a government's financial statement. This article will highlight the changes relating to Statement No. 68, focusing on how the new standard will assist state and local policymakers and the public to better understand their pension liabilities.

In June 2012, the Governmental Accounting Standards Board approved two new statements to improve the accounting and financial reporting of pensions by state and local governments and pension plans. The guidance contained in these statements changes how governments calculate and report the costs and obligations associated with pensions in many important ways. The new statements were designed to improve the decision-usefulness of reported pension information and to increase the **transparency**, **consistency** and **comparability** of pension information across governments.

GASB Statement No. 67, *Financial Reporting for Pension Plans*, addresses new financial reporting for state and local government pension plans. GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, establishes new accounting and financial reporting requirements for governments that provide pensions for their employees. This article focuses primarily on Statement No. 68, which takes effect for fiscal years beginning after June 15, 2014. For most states, this means the new standard will be effective for the fiscal year ending June 30, 2015.

The new guidance primarily affects employers that participate in *defined benefit* pension plans. It also changes accounting and financial reporting for non-employer contributions in special funding situations, such as where a state is legally required to contribute to a pension plan that covers local school districts' teachers.

Given the growing concern about the unfunded liability of public pension plans in the United States, these new GASB statements are very timely and important.

Background

State and local governments provide pension benefits through various types of *defined benefit* pension plans, which specify the amount of benefits to be provided to employees upon retirement. *Single-employer* pension plans provide pension benefits to the employees of one employer, while *multiple-employer* pension plans provide pension benefits to the employees of more than one employer. Under an *agent* multiple-employer pension plan, the assets of a multiple-employer pension plan are pooled for investment purposes, but separate accounts are maintained for each individual *agent employer*, so that each agent employer's share of the pooled assets is available to pay the pensions of only its employees. In a *cost-sharing* multiple-employer pension plan, *cost-sharing employers* share their assets *and* their obligations to provide pension benefits to their employees; plan assets can be used to pay the pensions of the employees of any employer that provides pensions through the plan.

GASB Statement No. 68 relates to *accounting and financial reporting* issues only. It does not address how governments approach pension plan *funding*. Instead, funding is a policy decision the government should make as part of the government budget approval process. While there historically has been a close relationship between how governments fund pensions and how they account for and report pension information, the new standard shifts from a *funding-based* approach to an *accounting-based* approach. This is an important change governments must understand and communicate to their governing bodies.

Pension accounting is a complex area. The sections that follow present a high-level overview of the major changes in GASB Statement No. 68 with an emphasis on how the new standard will increase transparency, consistency and comparability.

A Summary of the Major Changes

Recognizing a Liability Related to Pension Promises for Single and Agent Employers

State and local government employees often earn two types of compensation in return for their efforts—current compensation and deferred compensation. Employees also receive salaries and other forms of current compensation reflected in the paycheck during their employment. Employees do not receive deferred compensation, including pension benefits, until after their tenure with the government has concluded and vesting and age requirements have been met.

Nevertheless, a government has a present obligation to pay these deferred benefits in the future—a total pension liability—once they have been earned. When the total pension liability exceeds the pension plan's net assets—now referred to as plan net position—available for paying benefits, there is a net pension liability. Governments now will be required to report that amount as a liability in their accrual-based financial statements—for example, the government-wide statement of net position—raising the awareness of the pension expense and liability to the attention of citizens and governing bodies.

This is an important change that will more clearly depict the government's financial position. While this information will, in some cases, give the appearance that a government is financially weaker than it was previously, the financial reality of the government's situation will not have changed. Reporting the net pension liability—or asset, if plan net position exceeds the total pension liability—on the face of the financial statements will provide more transparency about the government's financial status because the pension liability will be placed on an equal footing with other long-term obligations.

GASB No. 68 significantly alters accounting and financial reporting for employers in single-employer and agent plans with regard to each of the following:

- The amount to be reported as a liability by the employer;
- The amount to be reported as pension expense by the employer;
- The discount rate used to calculate the present value of the employer's obligation;
- The method used by the actuary to allocate costs; and
- The technique used by the actuary to compensate for changes in assumptions and for differences between assumptions and actual results.

Measuring the Pension Liability

Under current standards, employers report a liability for pensions only if they fail to fully fund their actuarially determined annual required contribution. Under Statement No. 68, employers will have to report a *net pension liability* for the difference between the present value of the benefits earned to date by employees, the *total pension liability*, and the accumulated resources held in trust to pay those benefits, the *plan net position*. Using a very simple example, this change might be compared to the difference between a homeowner reporting a liability for arrears in monthly mortgage payments versus a homeowner reporting a liability for the unpaid balance of the underlying mortgage. Clearly, this is a major change and will likely result in an increase in the pension liability reported on the balance sheet of most state and local governments.

Determining the Pension Expense

Currently, the amount an employer reports as pension expense is based on the amount that the actuary calculates the employer should be contributing each period—that is, the employer's annual required contribution—to accumulate sufficient resources to pay pension benefits on a timely basis. Thus, the calculation of pension expense has historically been described as "funding driven." In contrast, GASB Statement No. 68 requires that the calculation of employer pension expense be driven by changes in the employer's net pension liability, rather than by funding. Accordingly, GASB believes the new standard will better align the recognition of pension expense with the period in which the related benefits are earned, providing more consistency in pension reporting.

Applying a Discount Rate

To discount projected pension benefit payments to a present value, governments assume a *discount rate*. Standards now in effect require governments to apply a discount rate equal to the long-term expected rate of return on the investments of the pension plan. Under the current rules, many state and local governments use a discount rate of approximately 8 percent. In recent years, critics have argued that this rate of return is too high, thereby lowering the overall pension liability.

Under GASB Statement No. 68, the long-term expected rate of return will continue to be the starting point for the discount rate. If, however, a government reaches a *crossover point*—a point when projected benefit payments for current and inactive employees exceed the projected plan net position related to those employees—then benefit payments projected to be made from that point forward will be discounted using a high-quality municipal bond rate. GASB believes this liability-based rate is appropriate because the plan would no longer have sufficient assets related to those employees to produce investment income that will reduce how much an employer will have to contribute.

Using the lower municipal bond rate as the discount rate increases the present value of projected benefit payments and, therefore, increases the size of the pension liability. The larger liability, placed on the face of the balance sheet, may be shocking for some governments. It will be very important for government finance managers, comptrollers and auditors to clearly explain the reason behind the change in the pension liability.

Actuarial Methods to Allocate Costs

Actuaries currently use a variety of methods—entry age, frozen entry age, attained age, frozen attained age, projected unit credit or aggregate—to calculate employer contributions for funding purposes. Under GASB Statement No. 68, all employers will use a single method, entry age, for accounting and financial reporting, regardless of the method selected for funding. While some differences may still exist, the use of entry age should significantly increase the comparability of pension information reported by governments.

Changes in Assumptions/Differences Between Assumptions and Actual Results

A number of circumstances could affect the calculation of an employer's net pension liability. These include:

1. A change in benefit terms;
2. A change in economic and demographic assumptions; or
3. A difference between an economic or demographic assumption and actual experience.

The net effect of these items is amortized over a period not to exceed 30 years. Under GASB Statement No. 68, a much shorter amortization period must be used. For example, a change in benefit terms must be recognized immediately, while a change in economic and demographic assumptions must be amortized over a closed period equal to the average remaining service period of plan members, including retirees. Differences between expected and actual investment returns must be amortized over a closed five-year period. These shorter amortization periods likely will serve to increase the government's pension expense.

Reporting by Governments in Cost-Sharing Multiple-Employer Plans

GASB Statement No. 68 also proposes significant changes in accounting and reporting for employers that participate in cost-sharing defined benefit pension plans. Under the pension standards now in effect, cost-sharing employers have not been required to present actuarial information about pensions. Instead, information has been required to be presented in the pension plan's own financial statements for all of the participating governments combined.

GASB concluded that the needs of users of information regarding cost-sharing employers do not differ significantly from those interested in single and agent employers. Therefore, GASB believes it is important to give users of the financial statements of cost-sharing employers access to better, more transparent financial information. Consequently, under Statement No. 68, GASB is requiring cost-sharing governments to report a net pension liability, pension expense, and pension-related deferred inflows and outflows of resources based on their proportionate share of the collective amounts for all the governments in the plan. This is a major change for participants in these plans, but GASB believes this change will result in a more accurate reflection of the plan participant's pension expense and liability.

Note Disclosures and Required Supplementary Information

Statement No. 68 also requires employers to present more extensive note disclosures and required supplementary information, including disclosing descriptive information about the types of benefits provided, how contributions to the pension plan are determined, and assumptions and methods used to calculate the pension liability. Single and agent employers will disclose additional information, such as the composition (i.e., in terms of "active" vs. "inactive") of employees covered by the benefit terms and the sources of changes in the components of the net pension liability for the current year. A single or agent employer also will present RSI schedules covering the past 10 years regarding:

- Sources of changes in the components of the net pension liability;
- Ratios that assist in assessing the magnitude of the net pension liability; and
- Comparisons of actual employer contributions to the pension plan with actuarially determined contribution requirements—if an employer has actuarially determined contributions.

Cost-sharing employers will present the RSI schedule for net pension liability, information about contractually required contributions and related ratios.

Governments also are now required to present notes to the RSI schedules regarding factors that reflect trend information. Significant assumptions should be disclosed. GASB believes these enhanced note disclosures and RSI requirements will provide more transparency on the financial condition of public pensions.

Special Funding Situations

Special funding situations are circumstances in which a non-employer contributing entity, such as a state government, is legally responsible for contributions directly to a pension plan that is used to provide pensions to the employees of another government, such as school districts located within that state and:

1. The non-employer is the only entity with a legal obligation to make contributions directly to the plan; or
2. The amount of the contributions for which the non-employer is legally responsible is not dependent upon one or more events unrelated to the pensions.

In these cases, GASB Statement No. 68 requires the non-employer contributor in a special funding situation to recognize in its own financial statements its proportionate share of the net pension liability, pension expense, and pension-related deferred inflows and outflows of resources.

The Period of Transition—Education Will Be the Key

GASB Statement No. 68 is bringing significant change to financial reporting for pensions of state and local governments. It is anticipated that many governments will see a significant increase in the pension liability on the balance sheet. Education will be very important so citizens and legislative bodies do not panic; they will need to have an understanding of the new standards. Auditors, comptrollers and treasurers in state and local governments will play a key role in this education process.

While the potential increase in the pension liability resulting from GASB Statement No. 68 may be a bitter pill to swallow for governments as they see for the first time a net pension liability on their balance sheet, GASB and many others believe the new standard will serve to greatly enhance transparency, consistency and comparability of public pensions.

About the Author

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