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Pension Accounting for Governments - Changes Are Coming

Reforming pension accounting.

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Reforming pension accounting has been on the agenda of the Government Accounting Standards Board (GASB) for some time. Recently, the GASB issued two exposure drafts proposing improvements to financial reporting of pensions by state and local governments and the financial reporting by pension plans.

The first exposure draft (ED), which addresses financial reporting by governments, proposes amendments to improve how the costs and obligations associated with the pensions that governments provide to their employees are measured and reported. The second ED provides a framework for the financial reporting by the plan. Both EDs will result in significant changes in reporting by governmental employers and plans.

This *Insight* provides an overview of the first exposure draft.

Background

In January 2006, the GASB began researching the effectiveness of the current accounting and financial reporting model for pensions[1]. At the

[1] GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* and GASB Statement No. 50 *Pension Disclosures* are the current accounting standards which govern pension

time, GASB viewed the unfunded pension obligation as a liability to be reported in the financial statements in the future, rather than as a liability of the employer or plan. Both the employer and the plan reported information about the total liability (funded and unfunded) in the notes to the financial statements and as required supplemental information.

Since that time, GASB has put an entirely different financial reporting model for governments in place. Additionally, it has made significant inroads into developing its conceptual framework for financial reporting, including formally establishing the definition of a liability for purposes of governmental financial reporting.

Additionally, due to the often severe underfunding of public pension plans, there is an increasing need among users of government financial statements (including investors in municipal bonds) for more transparent information about pension costs and obligations.[2]

In June 2010, the GASB issued a preliminary views document that outlined some of the key proposals on which it was seeking feedback. Comment letters on the preliminary views and other feedback from outreach activities by the GASB assisted the Board during the deliberations and development of the tentative decisions that were proposed in the recently issued exposure drafts.

PwC Observation: *The scope of the ED does not include other postemployment benefits (OPEB), such as retiree health care plans. In April 2011, the GASB added a separate project to their agenda regarding OPEB accounting and financial reporting. Because the board views all postemployment benefits similarly -- all involve deferred compensation for services provided -- the proposed changes in the pension standards are likely to be a bellwether for the direction the board will take with respect to the OPEB standards.*

Overview of Changes

Types of Benefit Plan Arrangements

Consistent with existing rules, the proposed statement classifies employers in one of the following categories depending on the type of benefit plan arrangement:

accounting and disclosures for governmental entities.

[2] Other efforts to improve disclosure of pension information are occurring outside of the financial statement arena. For example, the National Association of Bond Lawyers (NABL) has a project underway that aims to improve pension-related disclosures in municipal bond offering documents. For more information on that project, see www.nabl.org.

- *Single employers* - Employers provide their employees with defined benefit pensions through single-employer pension plans (plans where pension benefits are provided to the employees of only one employer).
- *Agent employers* - Employers provide employees with defined benefit pensions through multiple-employer pension plans (plans where plan assets are pooled for investment purposes but are legally segregated to pay the pensions of each employer's employees).
- *Cost-sharing employers* - Employers provide employees with defined benefit plans through cost-sharing multiple-employer pension plans (plans where participating employers pool or share their obligations to provide pensions to their employees, and plan assets can be used to pay the pensions of any participating employer's employees).

While these classifications are not new, the financial reporting for each would change significantly. Existing standards require information about the difference between a government's total pension obligation and the assets formally set aside for payment of those obligations -- the unfunded liability -- be discussed in notes to the employer's financial statement and required supplementary information.

Under the proposed standard, all employers would be required to recognize the obligation associated with the pension benefits promised to their employees through a qualified trust in their financial statements, regardless of the type of benefit plan arrangement used.goes here.

Changes Affecting Single and Agent Employer Plans

Net Pension Liability

For governments with single or agent employer plans, the net pension liability represents the employer's total pension liability less the amount of plan assets (the net position of the plan) formally set aside for payment of benefits as of the reporting date .

For example, an employer with a $1 million total pension liability and $800,000 in plan assets would report $200,000 as a net pension liability. The total pension liability represents the portion of the present value of projected benefit payments that is attributed to employee's past periods of service.text goes here.

Measuring the Total Pension Liability

Projections of Benefit Payments

The first step in measuring the liability requires projection of future benefit payments. Under the proposed rules, when projecting the future benefit payments to employees, projected salary increases (if the pension formula is based on compensation levels), service credits (if the pension formula is based on periods of service), projected automatic cost-of-living adjustments (COLAs), and other automatic postemployment benefit

changes that are considered to be "substantively automatic" need to be considered.

PwC Observation: *The proposal would require ad hoc COLAs -- that is, cost-of-living adjustments made at the discretion of the employer -- to be included in the benefit projections if the employer's past practice and future expectations of granting them indicate they are considered to be "substantively automatic". This is a divergence from the current requirement and would likely result in a larger obligation for many governments.*

Discount Rate

Once the future benefit payments have been projected, these payments need to be discounted to present value using a discount rate. Currently, the standard requires governments to apply a discount rate that is equal to the expected future rate of return on the investments of the pension plan over the long term. Under the proposed standard, determination of the single, blended discount rate would be developed in two parts.

1. The long-term expected rate of return on plan investments would be used to the extent plan assets are projected to be sufficient to make projected benefit payments
2. Any excess projected benefit payments would be discounted using a tax-exempt, high-quality 30-year municipal bond index rate

PwC Observation: *The proposed changes to the discount rate are one of the most controversial areas of the proposal. Because the municipal bond index rate is lower than the rate of return of investments today, the blended discount rate would be lower that than the rate used by governments at present, and thus would result in a larger expected liability.*

Attributing Present Value to Specific Periods

After projected benefit payments have been discounted to their present value, they are allocated over a period related to the years when the employees worked or are expected to work for a government and earn benefits. Under the current standard, governments can choose among six methods for attributing the present value of benefit payments to specific years for accounting and financial reporting purposes.

Under the proposal, all entities would be required to use the entry age normal method applied as a level percentage of payroll. The GASB believes that moving to a single required method would significantly improve the comparability of pension information.

Frequency and Timing of Actuarial Valuations

The current requirement that actuarial valuations be prepared every two years would be continued. However, because employers would be required to measure their pension liability as of the

end of the employer's reporting period, employers would either have an actuarial valuation prepared as of the employer's fiscal year end or would roll forward the information from an actuarial valuation prepared no more than two years prior to the employer's most recent year end.

PwC Observation: *These roll forward procedures would represent a new process for employers. Consideration should be given to how the roll forward will be performed, and whether changes identified in the roll forward period may indicate that an updated actuarial valuation is necessary.*

Measuring Pension Expense

At present, pension expense is represented by the "actuarially-required contribution" to the plan (known as the ARC). Under the proposed standard, pension expense would include the following components each year:

1) Pensions earned
2) Interest on the total pension liability
3) Changes in benefits
4) The effect on the total pension liability of differences between assumed and actual economic and demographic factors and changes of assumptions as they relate to inactive employees
5) Projected earnings on plan investments and
6) Changes in plan assets other than investments (e.g., employer and employee contributions, plan administrative expenses)

Currently, only 1), 2) and 6) generally are incorporated into the calculation of pension expense (that is, the ARC) immediately. The other components -- the impact of benefit changes, differences in assumptions, and projected earnings on plan assets -- are incorporated into the ARC over a period of up to 30 years.

The proposal would accelerate the recognition of these other items. For example, the effect of benefit changes would be recognized in the period of the change.

The effect of differences in assumptions on benefits related to *inactive* employees would be expensed in the period the assumptions change, while the effect of differences in assumptions on *active* employees would be deferred and reported in the balance sheet as a deferred outflow of resources or deferred inflow of resources. This deferred inflow/outflow would be systematically incorporated into pension expense over the average remaining service period of those employees.

Differences between projected earnings on pension plan investments and actual earnings would be deferred and incorporated into expense over a five year period.

PwC Observation: *The use of deferred inflow and deferred outflow accounts has not previously been a part of pension accounting literature under GASB. Employers will need to consider the appropriate financial reporting for these accounts, and understand the detailed rules proposed for determining the appropriate periods over which to amortize amounts initially recognized as deferred inflows/outflows.*

Changes Affecting Cost Sharing Plans

The GASB views user's needs for information regarding governments participating in multi-employer cost-sharing plans as not substantially different from the needs of users of single-employer and agent-employer financial reports. Therefore, the proposal would require a government participating in a cost-sharing plan to report a liability in its own financial statements that is equivalent to its proportionate share of the collective net pension liability of the plan.

This proportion would be based on the individual government's long-term expected contributions to the plan compared to those of all the participating governments. Each employer would also be required to recognize its estimated proportionate share of the plan's collective pension expense and deferred outflows/inflows of resources.

PwC Observation: *This proposed requirement is another controversial aspect of the proposal, as the majority of state and local governments participate in cost-sharing plans. Assume that a state sponsored plan has 1,000 participating employers and an unfunded liability of $1 billion. If one large government represents 5% of the plan's collective unfunded liability, under the proposal it would be required to reflect $50 million of net pension liability on its financial statements (unless the state has the legal responsibility to make contributions on the employer's behalf -- see "Special Funding Situations" below).*

The collective total pension liability would be measured at the end of each participating employer's reporting period. The measurements would be based on a single actuarial valuation performed at the plan (collective) level, supplemented by an allocation of information produced by that actuarial valuation to individual employers for their accounting and financial reporting purposes.

PwC Observation: *Participants in a multi-employer cost-sharing plan often have year-ends that differ from the plan's year end as well as from each other's. Concerns have been expressed about the time, effort and costs required to prepare and audit separate measures for inclusion in each employer's financial report at different times during the year.*

Disclosures and Required Supplementary Information (RSI)

Under the proposed standards, governments would continue to disclose information about their pension obligations in both the notes to the financial statements and in required supplementary information (RSI) following the notes. The requirements for note disclosures and RSI differ based on the type of benefit arrangement (i.e., single, agent or cost-sharing). The following outlines a summary of the required note disclosures and RSI.

For all types of benefit arrangements, a description of the benefits and assumptions used to measure the total pension liability are required to be disclosed.

Governments with single and agent plans would disclose:

- Beginning and ending balances of the total pension liability, plan net position and the net pension liability as well as the effects on the balances during the current period
- Amount of pension expense recognized during the current period (including separate identification of the components of pension expense such as service cost and interest)
- Separate reconciliations of beginning and ending balances of deferred outflows of resources and deferred inflows of resources related to pensions with separate identification of each change

Governments with single and agent plans would present RSI schedules covering the past ten years with information on:

- Beginning and ending balances of the total pension liability, plan net position and the net pension liability as well as the effects on the balances during the current period
- Ratio of plan net position to the total pension liability, the amount of covered-employee payroll, the net pension liability as a percentage of covered-employee payroll
- Notes to these required schedules

Governments with a cost-sharing plan would present these same RSI schedules but for the plan as a whole. These governments would also disclose the total pension liability, the plan's net position, the net pension liability, the ratio of plan net position to total pension liability, the covered-employee payroll and the ratio of net pension liability to covered-employee payroll for its proportionate share of the aggregate amounts.

Special Funding Situations

In some pension plans, an entity other than the employer government (for example, a state government) is legally responsible for making some or all of the employer's contributions to the plan. The proposed standard also includes accounting and disclosure

requirements for these "special funding situations" for both the employer and the other government legally responsible for contributing to the plan (the "nonemployer").

The accounting differs based on whether or not the nonemployer's obligation to contribute is conditional or unconditional. If the obligation is conditional, both the employer and nonemployer treat the portion paid by the nonemployer as if it were a grant provided to the employer.

If the nonemployer's obligation is unconditional, both parties' financial reporting reflects the fact that the nonemployer has essentially undertaken a portion of the employer's pension obligation as its own. The employer would be required to calculate its net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense irrespective of the nonemployer entity's support.

However, its statement of net position would only reflect its proportionate share of the net pension liability and deferred outflows/inflows of resources. The employer would recognize its pension expense in full, but would recognize revenue (essentially, a grant) for the portion that will be contributed by the nonemployer.

The employer would disclose in the notes to its financial statements information about the amounts assumed by the nonemployer and would present additional information in schedules of required supplementary information about the nonemployer's involvement in financing the pension benefits.

Similarly, the nonemployer's financial statements would reflect its proportionate share of the employer's net pension liability, deferred outflows (inflows), and pension expense. The nonemployer's share of the pension expense would be classified as a grant made (rather than as pension expense).

If the nonemployer is responsible for a "substantial" portion of one or more employers' pension liabilities, it would present information regarding those amounts in its notes and RSI that generally are consistent with the requirements for cost-sharing employers. Otherwise, less detailed disclosures and RSI would be required.

Defined Contribution Pension Plans

Defined contribution pensions stipulate only the amounts to be contributed to an employee's account each year and unlike defined benefit pensions, do not specify the amount of benefits employees will receive after the end of their employment. Governments participating in defined contribution pensions would essentially continue to follow the existing requirements.

Effective Date and Transition

For employers with large sole employer plans (that is, plans with over $1 billion in net position) that are not associated

with special funding situations, the requirements of the proposed standard would be effective for periods beginning after June 15, 2012. For all others, the requirements would be effective for periods beginning after June 15, 2013. Earlier application would be encouraged.

The proposed standard requires retrospective application to the extent it is practicable. In cases in which full retrospective application is not practicable (for example, as might be the case with deferred inflow/outflow balances), the cumulative effect of applying the statement would be reported as a restatement to the beginning net pension liability of the earliest period presented.

PwC Observation: *For example, assume that a government with a September 30 year-end has a single employer pension plan with more than $1 billion in net position. The employer presents single year financial statements. For purposes of implementing the standard in its September 30, 2013 financial statements, that government would be required to determine the total pension liability and related deferred outflows (inflows) of resources (if practicable) at October 1, 2012 (the transition date) and again at September 30, 2013 (the reporting date). The September 30, 2013 statements would include pension expense calculated in accordance with the new standards.*

With respect to the 10-year schedules that should be presented as RSI, information should only be presented for those years for which information is available initially which has been measured in accordance with the statement.

Next Steps for Governments

The proposed pension standard is on a fast track, with release of a final statement scheduled for mid-2012. Therefore, governments should begin thinking ahead now about what would be required if the new standards are issued as proposed. Next steps for consideration are as follows:

- Analyze current vs. proposed GASB and how it will impact your government's financial statements (anticipated increase in liabilities, anticipated increase in salary, wages and benefits expense, impact on key financial ratios)
- Assess new information that would be needed to comply with the proposed standard and compare to what is currently received
- Determine whether any rollforward procedures will be needed based on expected date of actuarial valuation versus employer's year end
- Evaluate whether there are potential implications on restrictive debt covenants which should be discussed with bond or other debt holders
- Estimate efforts (hours, resources, costs, etc.) needed for implementation of the proposed standard and ongoing - assess whether additional resources (for ex. accounting, actuarial, etc.) will be needed

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How PwC Can Help

PwC has considerable expertise in the accounting and actuarial issues related to pension plans. Please contact one of the individuals listed below, or your local engagement partner, to further discuss how PwC can help.

For more information, please do not hesitate to contact the authors or your local PwC professional:

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