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PENSION & BENEFITS



DAILY

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Proposed GASB Standards Would Alter the Meaning of Pension Expense



BY PAUL ANGELO

On June 16 the Governmental Accounting Standards Board issued several proposed accounting changes for public pensions that pension actuary Paul Angelo described to BNA as “game changers.”

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This Insights piece is based on Angelo’s June 17 interview with BNA, in which he analyzed GASB’s Preliminary Views document on proposed changes in standards for recognizing and reporting pension liabilities and expenses.

Several of the proposals that GASB released for public comment are game changers. One of them would change the placement of public pension plan liabilities on an employer’s financial statements. Another would alter how liabilities are recognized as pension expense and would change the relationship between pension expense and plan funding. Others would change how liabilities are measured and how “cost sharing” employers report their plan liabilities.

Game Changer No. 1: Reporting Liabilities

Let’s start with liability reporting. Public pension plans have always reported their unfunded actuarial accrued liability, which is the portion of their accrued pension costs that are not covered by plan assets. GASB’s Preliminary Views document introduced a new term, net pension liability, for that unfunded liability,

but it is basically the same as what we now call the unfunded liability.

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When you calculate the cost of a pension plan, you start with the cost for the next year, which is called the normal cost. In a perfect world, that is all you would ever have to pay as the plan sponsor. But, of course, this is not a perfect world. So with each valuation, you have to ask this question: Am I up-to-date in funding my accrued costs? That is, do I have enough assets to cover all of my plan costs for service to date? If the answer is no, then in addition to paying the normal cost, you must make a payment, like a mortgage payment, on your unfunded actuarial accrued liability.

Under current GASB standards, that unfunded liability is no secret. Bond underwriters and others accustomed to reading financial statements know where to find the pension liabilities of public employers. The liabilities are found in the mandatory notes that supplement the employer's financial balance sheet. The notes provide a six-year history of a plan's unfunded liability. Each year that unfunded liability goes up as you add a new year of normal cost plus interest on the previous balance. It goes down each year when you make contributions to the pension plan. The unfunded liability also goes up or down depending on plan experience and whether the plan is amended or assumptions are changed.

All of this information is background for the first game changer: GASB's proposal to move the reporting of unfunded actuarial accrued liability from the notes to the balance sheet portion of the employer's basic financial statements. This change would give the unfunded liability a more prominent position.

Moving the unfunded liability to the balance sheet is a big deal, and it would be surprising if GASB changed its mind on this. A brief explanation of what is driving this proposal might be helpful.

A recent GASB project called Concept Statements analyzed various accounting terms by asking conceptual questions such as these: What is a liability? Where should a liability be reported? Based on its new understanding of liability at a conceptual level, GASB concluded that the entire unfunded liability, the net pension liability, is a bona fide accounting liability and should be on the plan sponsor's balance sheet instead of in the footnotes. According to GASB's analysis of the unfunded liability, “it is a present obligation with little or no discretion to avoid,” and “it is measured with sufficient reliability” to be part of the employer's basic financial statement.

Importance of the ARC. So that you understand the effect of this proposed reporting change, we should say more about the current rules. In current practice, the unfunded actuarial accrued liability goes in the footnotes. (Technically, it is found in the Required Supplementary Information.) The number that goes on the balance sheet is called the net pension obligation. The net

pension obligation answers this key question: Have you been making contributions to your plan on an actuarially determined basis?

To calculate the net pension obligation, we must know perhaps the most important number of all: the plan's annual required contribution. The ARC is the pension expense for the year. It includes the normal cost for the year plus an annual payment on the unfunded liability. Each year we compare actual contributions and the ARC, and any difference between them is reflected in the net pension obligation. If you always fund the ARC, then your net pension obligation is zero. If you don't, then the net pension obligation measures how far behind or ahead you are on your contributions. Under current rules, the net pension obligation is the only pension information that goes on the employer's balance sheet.

To explain how this reporting works, let's use the example of a home mortgage. If you have a \$200,000 mortgage, then that amount, the amount of your entire mortgage, would be in the footnotes. That is the total amount that you are in debt, which in our example corresponds to the employer's unfunded liability. The only information that shows up on your balance sheet is the amount, if any, that you are behind on your mortgage payments. That amount corresponds to the employer's net pension obligation.

The idea is that if you always make your mortgage payments on time, although you still owe money, you are doing what you need to do to get out of debt. The footnotes disclose the debt and the balance sheet shows whether you are meeting your annual obligation to pay off the debt.

Enforcing Contribution Requirements. There is no federal law requiring public pension plan sponsors to fund their ARC, but the current accounting rules make it easy to tell which public employers do and which ones do not. Among state pension plans, two that we often hear about are New Jersey and Illinois. The primary reason they are in the news is that they do not consistently fund their ARC. The amount of the ARC that they have not funded is shown on their balance sheet as a net pension obligation. In California, because state law requires it, nearly all public pension plan sponsors fund their ARC, and so they have no net pension obligation on their balance sheets.

GASB has been quick to say that it is not in the business of enforcing any funding requirements because it has no authority to do so. GASB does have authority to set expense reporting standards, and under current standards, the expense requirement is a good de facto basis for making contributions. If an employer wants to do the right thing, it funds the ARC.

Even though the ARC, technically speaking, is an expense reporting requirement and not a contribution requirement, it is publicly understood and recognized as a measure of how much a public employer should be contributing to its pension plan. That is why, in current practice, only employers that have fallen short on funding their ARC show a net pension obligation greater than zero on their financial balance sheets.

The analogy would be that you report on the front page of your financial statement only the fact that you are behind on your mortgage payments. The amount of your mortgage is in a footnote. Under GASB's proposed change, public pension plans would be required to take

the entire amount of that mortgage and plop it on the front page. That's the first game changer.

Game Changer No. 2: Measuring Pension Expense

Calculating the ARC, or annual pension expense, gets us to the second game changer. We talked about reporting the unfunded liability, or net pension liability, and moving it from the footnotes to the balance sheet. GASB also proposed giving public pensions fewer years in which to expense changes in their unfunded liability. In addition to annual changes in normal cost and interest rates, other changes affect the amount of a plan's unfunded liability. Actuarial gains and losses, plan amendments, and changes in actuarial assumptions can significantly affect a plan's pension expense.

Actuarial Gains and Losses. Actuarial gains and losses occur when actual experience differs from what you assumed would happen. The unfunded liability goes up if you have an actuarial loss, which happens, for example, if a plan's retirees live longer than you assumed they would. That is good for the retirees but bad for the plan. Longer lives mean more benefit payments, which increase liability and create an actuarial loss.

Similarly, if plan investments lose value, or if investments do not increase in value at the assumed rate, which typically is 8 percent, your plan has a higher unfunded liability and, therefore, an actuarial loss. It goes the other way, too. If investments earn more than 8 percent, you have an actuarial gain, and your unfunded liability goes down from one year to the next.

Plan Amendments. Plan amendments also can change a plan's unfunded liability. If retirees get an ad hoc cost-of-living increase, the plan's unfunded liability will increase. Similarly, if active members get a benefit increase for past service, that additional benefit will increase the unfunded liability.

Changes in Actuarial Assumptions. Changes in actuarial assumptions can increase or decrease plan liabilities because they change our estimates of the benefits that will be paid or how much plan assets will earn. Many plan sponsors ask us to review their plans' actuarial assumptions every three to five years. We do this because we want the assumptions to be based on recent experience and future expectations specific to each plan. Based on these "experience studies," we tune up all of the assumptions so that we never get too far off base from the actual plan demographics.

GASB has proposed a new answer to the question of how quickly public pension plans sponsors must recognize an expense for each type of change in their unfunded liability. For this game changer, we are moving from the balance sheet to the income statement. The annual pension expense, or ARC, for each year's income statement will vary depending on how the ARC is calculated to reflect any changes in unfunded liability from actuarial gains and losses, plan amendments, or new assumptions during the past year.

In an invitation for comment that GASB issued last year, the board posed a question about when changes in unfunded liability should be recognized. Should they be recognized immediately, or can they be deferred and amortized? In its Preliminary Views, GASB answered this question by greatly limiting how much we can de-

fer or amortize the three types of changes in unfunded liability that we just described. This is the big one. It would completely change the meaning of pension expense, and that is why it is such a game changer.

Let's use an example in which we change an actuarial assumption. One assumption we pay attention to is mortality. People are living longer. We try to build in margins for future mortality improvement, but sometimes plan members live longer than expected. Let's suppose we have a plan with a \$2 billion liability, and let's just say that half of it—\$1 billion—is the plan's liability for active, working members. Basically, the active liability is the cost of their service to date. Another \$1 billion is the plan's liability for retired members. That retired liability is the entire cost of retiree benefits because the retirees will not be earning any additional service.

When we perform experience studies and discover that people are living longer than we assumed they were going to, we recommend a new mortality table. Under the new mortality table, let's suppose people live about 10 percent longer, and so now the new liability is \$2.2 billion. (I am oversimplifying to make the math easy.) The active liability is now \$1.1 billion, and the new retired liability is \$1.1 billion. The unfunded liability changed by \$200 million. What is the pension expense for the year?

Current Rule vs. Proposed Rule. Under the current accounting standard, you can take that \$200 million and recognize it as an expense by amortizing it over a period not to exceed 30 years. Many public pension plans amortize unfunded liability changes over periods of 15 years to 30 years. Some pension plans use different amortization periods depending on what caused the unfunded liability, but generally all of the amortization periods are in the range of 15 years to 30 years. In no case would the plans recognize the entire \$200 million as expense in the first year after a mortality assumption changed.

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Let's suppose I am using a 20-year amortization period and, to continue with the simple math, I am going to ignore interest. So \$200 million divided by 20 is \$10 million. Pension expense would not increase by \$200 million in a single year. Instead, it would increase by \$10 million this year and in each of the next 19 years during which I amortize the change in unfunded liability.

Under GASB's proposal, the amortization period for changes in active liability would be the average expected remaining service life of the active members. However, expected future service would not be calculated simply by assuming that active workers would re-

tire at 60, for example, and if they were 45 now, their expected future service would be 15 years. The calculation would be weighted by the change in actuarial liability, which in our example would mean the average future service would be less than 15 years. Weighting would shorten the amortization period for the \$100 million in increased liability for active, working members to about 10 years, instead of the 15 years to 30 years that public pension plans use now.

And what about the retirees? GASB stated clearly in the Preliminary Views document that for retirees you would also amortize unfunded liability during the period of expected future service. However, for retirees, expected future service would be zero, which would mean no amortization. You would have to recognize the entire \$100 million increase in retiree liability as a charge against earnings in the current year, the year in which you changed the mortality assumption. That is the second game changer.

What brought all of this about? Remember the Concept Statements from our earlier discussion of liability. GASB appears to be primarily focused on liability, which means that if you asked how much the pension expense is for the current year, GASB would ask how much did the liability change? Unless there is some reason to defer a change in liability from one reporting period to the next, GASB would want you to recognize the entire change in liability as an expense on the current year's income statement.

GASB's new views on pension expense may be partly in reaction to a practice common among public pension plan sponsors of adopting plan amendments that give benefit increases to retirees and then expensing the cost over periods as long as 30 years. One could argue that those changes in pension expense should be recognized in shorter periods because they are within the plan's or the plan sponsor's control. However, in its Preliminary Views, GASB lumped actuarial gains and losses and actuarial assumption changes together with plan amendments. Because GASB said it did so "to avoid unnecessary complexity," the proposed change is one that might be worthwhile asking GASB to reconsider.

GASB's new approach toward measuring pension expense could prove challenging for public pension plan sponsors and trustees. Trustees sometimes find it difficult to adopt more conservative assumptions. They would find it more difficult to do so if they had to expense changes in retiree liability in the current year and changes for working members over a shortened period.

In its Preliminary Views document, GASB did not directly address an even more difficult challenge. Using our example, suppose we were to point out to GASB that it would be unrealistic for current year taxpayers to pay off the entire \$100 million increase in retiree liability in a single year. GASB would respond that taxpayers would not be required to do that because the \$100 million is an expense requirement, not a funding requirement. But as we discussed earlier, the pension expense for the year, which currently is the ARC, is the de facto standard for public pension plan contributions. That de facto benchmark is the basis for the next game changer.

Game Changer No. 3: Redefining Pension Expense

The third game changer, in some ways the most important one, is little discussed in the Preliminary Views document. GASB's current accounting standards provide a clear linkage between pension expense and pension funding. For good reason, the pension expense for the year is called the ARC, the annual required contribution.

Under current GASB rules, the ARC serves as a de facto contribution standard. We discussed earlier how under current rules the balance sheet liability, which is the net pension obligation, measures whether past contributions are sufficient to cover the ARC. Current financial statements also include a schedule of employer contributions for each of the past six years. This schedule shows your ARC for each of those years, the amount you actually funded, and the ratio of one to the other. The mark of a responsible employer is having a 100 percent contribution ratio every year. Like having a net pension obligation of zero, having a 100 percent contribution ratio means the employer has funded its ARC, which is the actuarially determined annual required contribution. In GASB's terminology, that ratio demonstrates an employer's accountability, which is one of the primary purposes of financial reporting under GASB rules.

We described how GASB proposed changing the definition of pension expense to immediately recognize changes in retired liability that are the result of not only plan amendments but also plan experience and assumption changes. Although the current ARC is based on a reasonable contribution target, we cannot expect employers to fund pension plans on the new expense basis that GASB proposed. We would like GASB to clearly acknowledge the current linkage between pension funding and pension expense and, further, to acknowledge that the proposed rules would break that linkage.

Our clear preference would be that GASB maintain some connection between the accounting expense and the annual required contribution by developing a new definition of expense that, with limited exceptions, would be a viable basis for contributions. Otherwise, someone reading a schedule of contributions in the future would be unable to tell if employers were funding their pension plans as they should be.

If GASB's proposed accounting changes are adopted, they could have an unintended, detrimental effect on public attitudes about state and local government pension plans. Here's why. We would have two different "cost" numbers. We would have a funding cost, determined by the plan, which could remain unchanged. And we would have a separate pension expense, which would be different from the funding cost.

At the very least, this discrepancy would create confusion about which is the true cost. Even more worrisome, however, is that citizens would wonder and critics of public pension plans could claim that public employers that used to pay their annual pension costs had stopped paying them, even though employers were still funding their pension plans on the same, sound basis.

Breaking the linkage between the ARC and funding would have two downsides. First, you would lose accountability because you could not tell which employers were meeting their funding requirements. Second, you

would give the appearance of contribution misbehavior when there was none.

Other Proposed Changes

Other proposed changes in GASB's Preliminary Views document would affect the use of discount rates. GASB endorsed the current practice of using a long-term earnings rate for discounting the cost of future benefits, but only for future benefits that are projected to be covered by future assets. If future assets, including future contributions, are projected to run out before all benefits are paid to current members, any remaining payments would have to be discounted at a generally lower bond index rate. However, a plan that is 80 percent funded would not have to weight the bond rate 20 percent when determining its discount rate. The proposed change would affect only plans that are not making actuarially determined contributions based on a policy of funding all future benefits.

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We talked about recognizing changes in plan liabilities. GASB also proposed a new way of recognizing

changes in plan assets. The new approach would require plans to recognize as pension expense any cumulative difference between assumed and actual investment earnings outside a narrow range, with the odd result of decreasing expense volatility in some situations and increasing volatility in others. We expect there will be many comments critical of the practical effects of this proposal.

The last big proposed change would affect employers that participate in cost-sharing multiple employer plans. These are plans in which the employer's commitment is limited to the contribution amounts required by the plans. Cost-sharing employers do not report unfunded liability anywhere, not even in footnotes or schedules. Under GASB's proposed rules, these employers would have to show on their balance sheet a prorated portion of the unfunded liability of the entire plan.

Next Steps. How soon might some of these proposed changes take effect? The whole standards-setting process probably will take at least another three years. Comments on the Preliminary Views document are due in September. GASB will hold hearings in October and begin writing an exposure draft late this year. Sometime in the middle of 2011, GASB probably will issue an exposure draft, followed by a comment period and then more hearings.

If GASB gets it done on the first pass, we probably are looking at sometime in 2012 for the final standard. For this type of major revision, GASB usually gives some lead time for implementation, so that would mean 2013 or later for the effective date.

All interested parties should view GASB's Preliminary Views as simply that, preliminary and subject to change. I urge you to discuss these game changers with your colleagues and advisers, and then let GASB know what you think.