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The GASB's Proposed Changes to Pension Accounting and Financial Reporting by Employers

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On June 16, 2010, the Governmental Accounting Standards Board (GASB) issued its Preliminary Views (PV) on proposed changes to accounting and financial reporting standards. The proposed changes would (if approved) apply to state and local government employers that sponsor defined benefit (DB) pension plans. The PV is an intermediate step in the GASB's project to review the standards and reflects the GASB's expectation of significant discussion (and disagreement) related to the proposed changes. The GASB's changes would apply only within the context of accounting and financial reporting, and would not necessarily affect the actuarial calculations used to determine pension contributions or funding.

Current Pension Accounting and Reporting Standards

Before discussing the proposed changes, it may be useful to review the GASB's current pension standards for governmental employers, as presented in GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*. Under current standards, pension accounting measures are closely related to pension funding measures. Generally, the employer's pension expense for accounting purposes is the "annual pension cost" (APC) necessary to fund the plan. The APC consists of the employer's "annual required contribution" (ARC), plus certain adjustments if the employer has contributed more or less than the ARC over time. The ARC, in turn, is the actuarially determined cost of the benefits allocated to the current year (i.e., the "normal cost" or "service cost") plus the amortization of any overfunded or underfunded actuarial accrued liabilities and actuarial gains/losses over a maximum of 30 years.

In addition, under current standards, the employer's pension liability for accounting purposes is the "net pension obligation" (NPO). The NPO is calculated as the accumulated difference between the annual pension cost and the employer's actual contributions to the plan over time. Also, information about the employer's actuarial accrued liability, actuarial value of assets, and unfunded actuarial accrued liability are disclosed in other sections of the employer's financial report. Typically, the actuarial value of assets is determined using a method that averages (or smoothes) investment gains and losses over a period time, usually five years.

The GASB's Proposed Pension Liability

The GASB's proposed changes would disconnect the pension accounting measures from the pension funding measures. The GASB's proposed measure of the employer's pension liability would be the "net pension liability" (NPL). While intended to reflect the employer's unfunded pension obligation (rather than the difference between required and actual contributions), it

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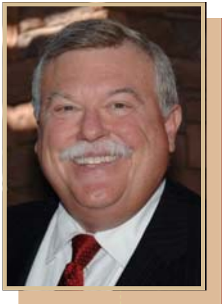
CAPITOL COMMENTARY

THE SEC, NEW JERSEY, AND GASB: ROADMAP FOR THE FUTURE?

By Leigh Snell, NCTR Federal Relations Director



The Governmental Accounting Standards Board (GASB) appears intent on changing public pension accounting and disclosure rules. As our cover story illustrates, these new rules would inflate employers' perceived pension costs, increase volatility in their pension liabilities, heighten public confusion over the adequacy of funding efforts, and eliminate proven, much-needed tools to help enforce funding discipline.

Media critics and opponents of public pensions point to GASB's proposals as proof that the current system hides the "real" cost of governmental plans and therefore needs reform. Now, to make matters worse, the U.S. Securities and Exchange Commission (SEC) has charged the State of New Jersey with securities fraud for misrepresenting and failing to disclose to investors in its municipal bonds that the state was underfunding its two largest pension plans.

How does this SEC action relate to GASB's current efforts? First, it is already being viewed as yet another indication that reforms are necessary. Although the charges concerned bond offering disclosures and were made against the state and not its pension systems, *The Wall Street Journal* nevertheless opined that the SEC's action was a sign that the "movement to clean up state pension funds is gaining momentum."

More importantly, while the SEC's order primarily deals with the state's failures to adequately disclose pension underfunding and its potential effects on the state's financial health, some of the findings in the SEC's cease and desist order suggest that certain accounting methodologies—currently permissible under existing GASB standards—are nevertheless problematic.

For example, the SEC said the state's five-year smoothing method produced net unsmoothed losses, and the resulting difference between the actuarial value of assets and their market value reduced the State's pension contributions. However, smoothing, by its very nature, virtually always produces actuarial values different from market values, and these differences can result in increases in a State's pension contributions, not just decreases. Nevertheless, the SEC faulted New Jersey for failing to adequately disclose the impact (presumably negative?) of smoothing.

The SEC also found New Jersey's use of a closed 30-year amortization period meant that the state "has been unable to and will continue to be unable to effectively amortize" its pension plans' unfunded actuarial accrued liability. The SEC acknowledged this was a "recognized actuarial method," but still charged that the disclosure of this methodology's (again, presumably negative?) impact on funding was inadequate.

Finally, the SEC complained that the bond offering documents did not provide asset and funded ratio information on a market value basis, although it noted they were available in the state plans' actuarial reports. Again, due to the significant difference between the actuarial value and market value of plan assets, the SEC found "the actuarial value did not accurately present the current value of the pension plans."

Will the SEC's problems in this particular area be perceived as having more to do with the impact of certain methodologies currently permitted by GASB standards, and not simply with the inadequacy of these methods' disclosure? If so, this sends a message to the public that GASB's rules need to be fixed. It sends a message to GASB that its current plans to restrict amortization, eliminate smoothing, and move to a market valuation of assets is the right direction to follow.

It's the wrong message, at the worst possible time. Be sure that GASB also hears your message that its current approach has generally worked well and that drastic changes are unnecessary and will be harmful.

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The GASB's Proposed Changes

would be determined differently than the unfunded actuarial accrued liability. First, in determining the NPL, the market value of plan assets would be subtracted from the total pension liability. This would introduce significant volatility into the measure of the NPL, since the market value of assets is not smoothed.

Second, depending on circumstances, the total pension liability could be measured using a different discount rate than the actuarial accrued liability. If the pension plan's current and expected future assets are not sufficient to cover expected future benefits, the accounting liability would be measured using a discount rate that reflects a blend of long-term expected investment returns and municipal bond yields. This "blended" discount rate would likely be significantly different than the discount rate used for funding purposes (i.e., the long-term expected investment return), and result in a measure of the pension accounting liability that is significantly different from the pension funding liability.

The GASB's Proposed Pension Expense

The GASB's proposed measure of the employer's pension expense would also be different from the annual pension cost (the current accounting measure of pension expense). Although both would be based on a similar measure of the service cost for the current year, they would use fundamentally different methods for amortizing actuarial gains and losses. Under current standards, actuarial gains/losses may be amortized over a period of up to 30 years. Under the proposed changes, actuarial gains/losses would be treated differently, depending on whether they arise from changes in the liability or from changes in assets.

Liability Gains/Losses

Since the future is unknown, determining the total pension liability depends on a variety of economic and demographic assumptions. These assumptions may be different from actual experience and, therefore, lead to differences between the expected pension liability and actual pension liability from year to year. To the extent these differences change the pension liability related to past service, they would need to be recognized in the pension expense. The same is true for changes in assumptions and benefits.

The GASB proposes amortizing these liability gains/losses over the average expected remaining service lives of active employees. However, to the extent the changes apply to vested inactive members (including retirees and beneficiaries), such changes would be recognized immediately. For accounting and financial reporting purposes, these proposed changes would reduce the amortization period for liability gains/losses from a maximum of 30 years to about 10 to 20 years (or less). This reduction in the amortization period, in turn, would likely lead to a higher and more volatile measure of the pension expense.

Asset Gains/Losses

Asset gains/losses occur when actual investment earnings are different from assumed investment earnings. The GASB proposes to defer recognition of these differences to the extent they are small relative to the value of assets. Specifically, the GASB proposes to defer recognition of the differences between actual and expected investment earnings to the extent they remain within a 15% corridor around the market value of plan net assets. However, when the cumulative difference between actual and expected investment earnings falls outside of the corridor, the excess portion would be recognized immediately. This suggests that asset gains/losses would be recognized infrequently, but also that sharp market declines or increases would likely be recognized immediately, increasing the volatility of the pension expense.

Conclusion

The changes proposed in the GASB's PV constitute a significant departure from the current pension accounting standards for state and local governments. The GASB prepared the PV specifically to inform stakeholders of the proposed changes and to request comments. Consequently, it is important to review the proposed changes, consider their impact, and respond. Written comments are due to the GASB by September 17, 2010, and public hearings are scheduled for October in Dallas, San Francisco, and New York.

Visit www.gasb.org to download GASB's preliminary views on major issues of the *Pension Accounting and Financial Reporting by Employers*. Instructions for submitting a comment are found within the document under "Request for Written Comments."

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SPEAKER HIGHLIGHTS

PETER LEYDEN
is a technology and future trends expert who was managing editor of the original *Wired* magazine, and at the center of the Global Business Network's pioneering think tank on the future.

MARK HALPERIN
is editor-at-large and senior political analyst for *TIME*, covering politics, elections, and government. He is also the creator and author of TIME.com's "The Page," a news and analysis tip sheet.

ROGER FERGUSON
is President and CEO of TIAA-CREF, and a member of President Obama's Economic Recovery Advisory Board and of the Board of Trustees of the Institute for Advanced Study.

SARAH BROWN WESSLING,
2010 National Teacher of the Year, inspires students and mentors colleagues in her role as English teacher at Johnston High School in Johnston, Iowa.

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SNAPSHOTs

In May, NCTR's Workshops for Deputy Directors, Communications Specialists, and Administrative Assistants held sessions in the inspiring new CalSTRS building in Sacramento.

In July, public system trustees from every corner of the US gathered in Portland, Oregon, for the NCTR 10th Annual Trustee Workshop.

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