DEC 2008-LOOKING BACK AT TEN YEARS OF PENSION REPORTING

THE USER'S PERSPECTIVE

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Looking Back at Ten Years of Pension Reporting

Standards of accounting and financial reporting are not set in stone. The economy, public finance, the governmental environment, and the information needs of decision-makers change over time. The information reported by state and local governments and the ways in which that information is communicated need to keep pace with those changes. Consequently, the GASB is committed to reviewing its standards, after they have been in effect for a sufficient amount of time, to assess whether they result in (1) an accurate portrayal of the economic substance of the transactions they address and (2) the provision of information that is useful for making decisions and monitoring the financial health of governments. In other words, the GASB seeks to ensure that its standards continue to *work.*

The GASB has embarked upon a project that will examine its standards of accounting and financial reporting for postemployment benefits—including pension benefits and other postemployment benefits (OPEB), most notably retiree health insurance. The project began with a two-year research effort aimed at understanding if the GASB's pension standards—Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers* —have been effective. Those Statements were issued in 1994 and were fully implemented by the late 1990s.

The Research Project

The research phase of the project examined how the pension standards had performed over nearly ten years of use, asking questions such as:

- Do the standards provide users with the decision-useful information they need? How have they used this information?
- How have governments implemented the standards in practice? What choices have they made about the methods and assumptions used to estimate their pension obligations and costs?
- Do the standards produce a full reflection of the financial transactions and other events related to postemployment benefits?

The GASB's comprehensive evaluation—under which the staff analyzed hundreds of financial reports and surveyed financial statement users, pension plans, and actuaries—involved an extensive review of the experience of governments and plans now employing these standards and an exploration of how the resulting information has been used. The GASB also initiated discussions about its pension standards through the formation of an advisory committee of experts from various relevant fields and by conducting four regional discussion forums. The discussions involved finance officers from government employers and pension plans, auditors, actuaries, municipal bond analysts, citizen groups, and other financial report users, and centered on the following issue: How well are the current standards working and what improvements, if any, could be made?

Potential Major Issues in the Current Project

Although the research did not find widespread dissatisfaction with the existing pension standards, it did identify a number of areas in which some constituents believe improvements could be made that would increase accountability, more accurately estimate the long-term obligations and annual costs associated with retirement benefits, or produce information that is more useful. The so-called "PEB" project (for **postemployment benefits**) is designed to unfold in several phases. In the current phase, the Board is developing an Invitation to Comment to discuss certain key issues raised by constituents in the context of pension accounting and financial reporting. An Invitation to Comment normally is issued to gather input on broad, underlying issues before the Board has begun to develop a consensus on possible improvements.

Overall approach

First and foremost, the Invitation to Comment will discuss the view of the transaction that underlies the current standards—that postemployment benefits result from an exchange between the employer and the employee, a part of the compensation that the employee receives for working. The document will ask constituents what aspect of the processes associated with that transaction should be the focus of information reported in an employer's financial statements—the process by which the benefits are earned, the process by which the government funds the benefits, or both.

What is the accounting liability ?

The next big questions raised for public consideration in the Invitation to Comment will ask: Can a government's obligation for postemployment benefits, or specific aspects of its obligation, be considered a *liability*? If so, should the liability be reported in the financial statements? At present, the long-term obligation that is calculated using actuarial methods is not reported as a liability, but is disclosed in the notes to the financial statements and in required supplementary information (RSI). A liability appears only if a government does not keep pace with the actuarially determined annual contributions required to provide sufficient assets to cover future benefit payments.

When the GASB issued its pension and OPEB standards, it did not have a formal definition of a liability. However, with the issuance of Concepts Statement No. 4, *Elements of Financial Statements,* in 2007, the GASB now has a benchmark against which to judge. According to Concepts Statement 4, "Liabilities are present obligations to sacrifice resources that the government has little or no discretion to avoid." With that definition in hand, the GASB can ask, What obligations associated with pension benefits meet the *conceptual definition of a liability?* If determined to be a liability, should an employer's accrued obligation be *recognized* in accrual-basis financial statements? If it should be recognized, how would *changes in the amount of the obligation* from one financial report date to another be recognized in the financial statements?

Parameters

Another issue that engendered considerable discussion during the GASB's research regards the *parameters* that the standards set for the methods and assumptions employed to estimate the long-term obligation and annual costs of pension benefits. The standards generally do not require governments to use a specific method or assumption, but rather set boundaries or limits on what can be used.

For example, actuarial calculations make an assumption about how much invested assets will earn over time—the rate of return—which also serves as the basis for the discount rate that is used to calculate the present value of future benefit payments. Rather than identifying a specific rate of return, the standards direct governments to employ one that is consistent with the assets that are expected to be used to finance benefits (a long-term rate). If a government has invested assets in a pension trust fund, a higher rate of return related to long-term investment might be appropriate, whereas a government funding benefits on a pay-as-you-go basis might more appropriately use a lower rate of return.

Actuaries utilize an *actuarial cost method* to allocate the cost of benefits over the future employment periods of the employees. The parameter standards do not require a single method, but allow governments to select from one of six, asking that governments choose one that is consistent with their approach to funding.

One concern relating to parameters is how to balance comparability across governments with how the governments actually administer their plans, which requires some flexibility. All other things being equal, greater flexibility could mean less comparability. Another concern depends on how the questions about the overall approach are answered. Views about what process pension reporting should focus on will affect if and how certain amounts—such as retroactive benefit increases—should be measured and recognized.

- The questions that will be posed in the Invitation to Comment flow from these underlying concerns:
- Should the number and types of acceptable actuarial cost methods be narrowed, broadened, or kept the same?
- Should *maximum amortization periods* and *amortization methods* be changed or left as is?
- To what extent, if any, should the effects of *retroactively applied benefit increases* (ad hoc cost-of-living adjustments, COLAs, or other modifications of benefit terms) *that are not substantively part of the employment agreement* be allowed to be deferred and amortized, and on what basis?
- Should the parameter on *benefits to be included* in the projection of pension benefits be modified to include additional ad hoc COLAs if they are substantively a part of the employment agreement?
- Should the basis for determination of the discount rate continue to be the long-term expected rate of return on assets, or should there be another basis (for example a current risk-free rate of return, the employer's borrowing rate, or some other)?

Reporting by pension plans

This chapter will address issues specifically related to the separately issued financial reports of pension plans. One question posed in this chapter will ask whether the pension obligation, however it is measured, should be considered a liability of the plan. At present, the obligation does not appear in plan financial statements as a liability, but is instead disclosed in the notes and RSI.

Another question of this chapter is, Should the plan financial report include a disaggregation of *changes in pension obligations by type?* Pension obligations change from year to year for a variety of reasons, including the performance of investments, switching methods and assumptions, and changes in benefits. However, one cannot attribute the change in the amount of the obligation to any specific cause based on the information currently included in the financial report. If readers of the Invitation to Comment believe that additional information about the causes of obligation changes would be valuable, then they will be asked where the information should appear (as a basic financial statement, in the notes, or as RSI).

Cost-sharing employers and other issues

The Invitation to Comment also will explore issues unique to governments participating in cost-sharing multiple employer plans. In these pension plans, the assets contributed by the participating governments are pooled and invested jointly, and the cost of benefits is shared among them. At present, the accounting approach for cost-sharing employers is different from that for governments with individual plans and those participating in agent multiple-employer plans (assets and costs of each participating government's benefits are kept separate from those of other participants). The Invitation to Comment will seek feedback on whether the economic substance of the relationship between a cost-sharing employer and a cost-sharing multiple-employer plan sufficiently differs from the relationship between a sole or agent employer and the plan in which it participates, to support continuation of distinct accounting approaches.

Implications for OPEB

Although the Invitation to Comment will be addressing pension benefits specifically, the project is called *Postemployment Benefit* Accounting and Financial Reporting, which encompasses health insurance and other forms of OPEB. Governments are, in fact, in the midst of implementing the GASB's standards for OPEB—Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans,* and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.*

However, the OPEB standards are very similar to the pension standards because the GASB views all postemployment benefits similarly—all involve deferred compensation for services provided. Therefore, any changes in the pension standards that might result from this project could *potentially* affect the OPEB standards as well. The GASB expects to consider what, if anything, should be done with its OPEB standards in a later phase of the project, subsequent to the release of the Invitation to Comment and analysis of the public response to it. Even if changes are eventually made to the OPEB standards, the length of this project and the period of transition would likely put the effective date well beyond the implementation period for the present standards.

First Steps

The issuance of the Invitation to Comment is tentatively planned for March 2009. The GASB also plans to release a plain-language supplement to the Invitation to Comment, which will discuss the issues with a minimum of technical jargon and focus on the implications of these issues for the information that financial statement users would receive.

In addition to a review period during which the public can read and comment on the documents, the GASB likely will hold one or more public hearings. After reviewing and analyzing the feedback it receives, the GASB will consider how to proceed with this project. Potential avenues include issuing a Preliminary Views, a document that seeks input on a tentative approach to addressing accounting and financial reporting issues, or an Exposure Draft of proposed standards.

Further Reading

- **Project Page**: Postemployment Benefit Accounting and Financial Reporting
- Summaries of GASB Statements **25**, **27**, **43**, **45**, and **50**