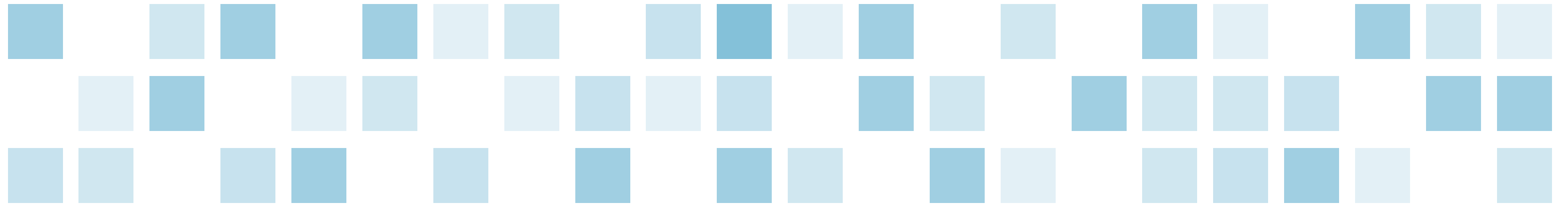
GASB Statement No. 68, Accounting and Financial Reporting for Pensions

A summary of the changes and recommended implementation steps



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More than ever before, there is a spotlight on the pension crisis, and solutions have been slow to evolve. GASB 68 will make pension issues more transparent.

Long before the current economic downturn, the issue of public pensions and the viability of individual plans has been a much-debated topic. The events of 2008 and beyond have only intensified the spotlight on this mounting problem. Management and those charged with governance have struggled to find solutions to the underfunding that many governmental plans face. Many of these plans are defined-benefit pension plans promising pre-determined monthly retirement benefits to employees, a costly practice that is rare in the private sector. The high costs of these plans have contributed to the underfunding trend.

The Governmental Accounting Standards Board (GASB) has been well aware of the rising tide of unfunded pension obligations, and in January 2006 the board added a new project on pension accounting and reporting to their research agenda. In April 2008, the GASB moved this project to its current agenda. The goal was to consider the possibility of improvements to the existing standards (primarily Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, hereinafter referred to as Statement 27); with a focus on improving the usefulness of information, as well as improving accountability and transparency in employer reporting of pension information. After an invitation-to-comment process, the GASB issued its exposure draft in July 2011 and received comments from 645 individuals and organizations. Public hearings, field tests and additional deliberations followed. After this arduous process, the GASB issued Statements 67 and 68 (plan and employer, respectively) in June 2012. Statement 68 brings the governmental employer accounting and reporting standards closer in line with the private sector requirements.

Statement 68 is effective for financial statements for fiscal years beginning after June 15, 2014.

Until the advent of the Statement 68 deliberations, there hadn't been this much publicity, controversy, admiration and disdain (depending on whom you ask) about a governmental accounting standard since the issuance of GASB 34, which created the current reporting model. Understanding this statement and all its implications requires reading the 63 pages of the document (which excludes the glossary, appendices, etc). The statement itself can be difficult to read because it contains technical jargon and new (or redefined) terminology; however, the examples and samples are very helpful.

The following summarizes several of the key changes and new requirements, and provides some first steps to consider before implementation to better manage the transition. Please keep in mind that this article is not a substitute for reading the statement in its entirety. There are numerous details in the statement that are not addressed herein.

I. Pension liability

Statement 27 required disclosure of the unfunded pension liability; however it was not recorded as a liability.

Currently under Statement 27, the amount reported as a pension liability in governmental financial statements results from a comparison of the actuarial required contribution (ARC), as adjusted, compared to actual employer contributions made during the reporting period. Governmental employers who had a pattern of underfunding their ARCs reported a year-to-year increase in their liability (net pension obligation). Governmental employers who demonstrated a pattern of fully funding their ARCs reported no liability, and governmental employers who funded more than the ARC reported an asset. The amounts reported as liabilities (or assets) in the financial statements do not represent the net unfunded (or overfunded) pension liability; instead they represent the cumulative funding of contribution requirements since the transition date set by the GASB in Statement 27 (1986 for most governments). This method does not fully consider a plan's actual performance compared to the actuarial assumptions used because these types of differences are amortized over periods into the future (up to 30 years).

The new calculation for the Net Pension Liability will have a material adverse impact on net position for many governments.

With the implementation of Statement 68, a new approach to recording the pension liability will be required and will be a closer measure of the unfunded actuarial liability. The recorded liability is termed the "net pension liability" and is calculated as follows:

Net pension liability =
Present value of projected benefit payments to current active and inactive employees attributable to past periods of service
Less
The amount of the pension plan's fiduciary net position (previously referred to as net assets)

The new liability is a measure of the promised benefits to employees for services performed, compared to the assets set aside to pay for those benefits.

Most (but not all) changes in the pension liability from year to year will be recorded as pension expense. Certain changes, including those pertaining to actual performance compared to assumptions, and economic/demographic assumption changes, will be amortized over a closed period. Amounts not recorded as expense in the reporting period will be reported as deferred outflows or deferred inflows of resources as appropriate.

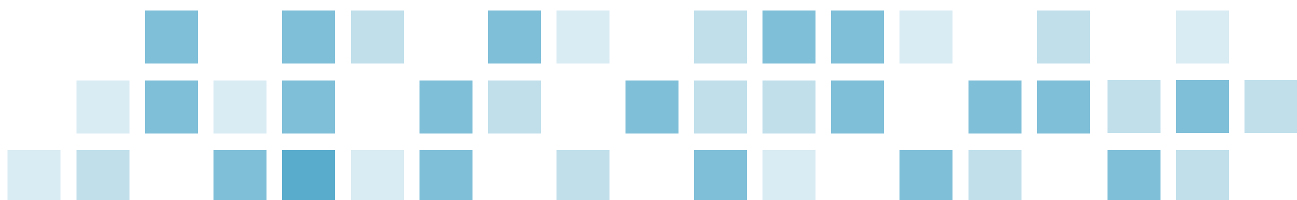
This new liability measurement will result in a material impact on net position for most governmental entities. Governments who previously reported a net pension asset (because they contributed more than the ARC) may now report a significant liability and those who reported a net pension liability may now report a much larger liability.

II. The discount rate

Because the use of the blended discount rate will significantly increase the liability amount, in most cases, the new liability will not be the same as the "unfunded actuarial accrued liability" calculated under the previous standards.

Under Statement 27, each employer would provide their actuary with a long-term rate of return (assumed RoR) on investments. This assumed RoR was used to discount the projected benefits to be paid to employees after retirement back to the present value. The higher the investment RoR assumption, the lower the present value of the future benefits to be provided. It was not uncommon to see assumed RoRs of 7 percent to 8.5 percent, particularly for large pension funds. The theory for using these rates was that pension funds were well positioned to undergo a long-term investment strategy and invest in a balanced portfolio that contained some high risk/high reward investment vehicles. Studies conducted over 15-to-20-year time horizons showed that significant investment portfolios with long-term strategies could achieve these high returns over time.

Under Statement 68, employers will still determine a long-term assumed RoR, which will be considered as long as certain conditions are present. Thereafter, a lower rate will be required. The two rates will ultimately be combined into a single discount rate.



The crossover point will likely become a topic of much interest by governing boards and management. Additionally, auditors may identify it as a significant risk.

Under Statement 68, as long as the plan's projected net position is sufficient to continue to invest in a long-term portfolio that achieves higher rates of return, the long-term assumed RoR may be applied. This estimation of net position will include projections of employee, employer and other contributions, investment earnings (at the appropriate RoR, see below), and projected benefits to be paid to current/inactive employees. The projection should include the current period through the end of the employee benefit lifecycle (i.e., projected death of employees in population). The projection will be performed for the same periods in which benefits are scheduled to be paid (most likely a monthly analysis will be required). Statement 68 provides further detail showing how to project the plan's net position. There are excellent examples in the appendices. Once the projected net position in the plan (pertaining to current and inactive employees) is no longer sufficient to cover the projected benefits owed to those employees (current and inactive), then a lower RoR must be used.

The point at which the projected Plan net position becomes insufficient to provide for current/inactive employee benefits is termed the "crossover point." Once this point has been achieved, the RoR used thereafter will be a much lower rate (based on a high quality municipal bond rate). This step will result in two rates used in the overall projection of plan net position. The long-term RoR will be used for the period until the crossover point, followed by the lower muni RoR used thereafter.

These rates are an important factor in discounting the projected benefit payments to their present value, as discussed below.

Projected benefit payments are required to be discounted to their actuarial present value using the single rate that reflects (1) the long-term assumed RoR up to the crossover point and (2) the tax-exempt, high quality municipal bond rate, after the crossover point. This present value amount is the main factor used in the liability calculation discussed below.

Although management will develop a long-term expected rate of return, auditors will need to be comfortable with the number.

Net pension liability =
Present value of projected benefit payments to current active and inactive employees attributable to past periods of service
Less
The amount of the pension plan's fiduciary net position

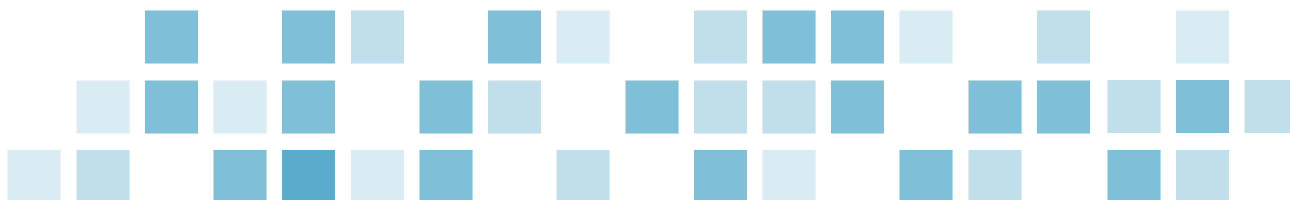
Plans that are extremely underfunded will more rapidly reach the crossover point, resulting in a discount rate that is close to the municipal bond rate. Plans that have been highly funded over the years could achieve a discount rate that is more in line with the long-term RoR.

Use of a discount rate that is lower than the historical long-term RoR will result in a higher present value of benefits to be provided to employees and thus a higher net-pension liability recorded in the financial statements. Overstating investment RoRs, and/or understating pension benefits promised to employees could alter the crossover date and will likely be a risk evaluated annually by auditors.

III. Cost-sharing plans

Employers in a cost sharing plan will record their proportionate share of the collective net pension liability.

If a defined benefit plan is used to provide pensions to the employees of more than one employer, it is termed a multiple-employer defined benefit pension plan. Cost-sharing employers are those whose employees are provided pensions through a multiple employer plan (MEP) that pools the assets. These plan assets can be used to pay the benefits of any employee of any employer in the plan (i.e., plan assets are not segregated into separate accounts by employer).



Statement 27 requires each employer to record an expenditure/expense for the contractually required contribution to this type of plan. The difference between contributions required and contributions made, if any, are recorded as an asset (excess amount) or liability (underfunded amount).

Under Statement 68, absent any special funding situations (which are addressed below), each employer in the cost-sharing plan will record a new liability representing their "proportionate share" of the collective net pension liability (liability as defined previously and which should include all covered employees, active and inactive, for all employers in the MEP plan). The proportionate share should be determined on a basis consistent with how the contributions for each employer are determined.

IV. Special funding situations

Many pension plans offered by local governments have special funding situations in which a non-employer governmental entity is legally required to provide for some, if not all, of certain "employer's required" contributions to the plan. For example, a state government might be required under law to fund the employer's contribution to the teacher retirement plan for all school district employers in the state. Under Statement 27, these state-funded amounts are recorded in the school district financial statements as "on-behalf" revenues and expenditures/expenses; however, there is no net pension liability recorded by the districts, and there is no impact on their fund balance or net assets. If state-funded amounts were less than the ARC in a given period, the state recorded the deficiency as a liability.

Certain states, counties and other large units of government will be required to record a net pension liability for pension benefits of nonemployees, resulting from their special funding situations.

Under Statement 68, governmental employers with defined benefit pension plans (and special funding situations) will be required to record a pension liability, with an adjustment for the involvement of the non-employer contributing entity. The approach for recording the pension liability and expense is similar to the approach required for cost-sharing employers. If the special funding situation legally requires the non-employer contributing government to contribute 100 percent of the actuarially determined past service cost, then the governmental employer's proportion of the collective net pension liability will be zero percent, and the non-employer governmental funding entity's proportion would be 100 percent (assuming no other contributing entities). These governmental employers will still have disclosure requirements pertaining to employee pension benefits, even if the entire liability is to be funded by the non-employer contributing government.

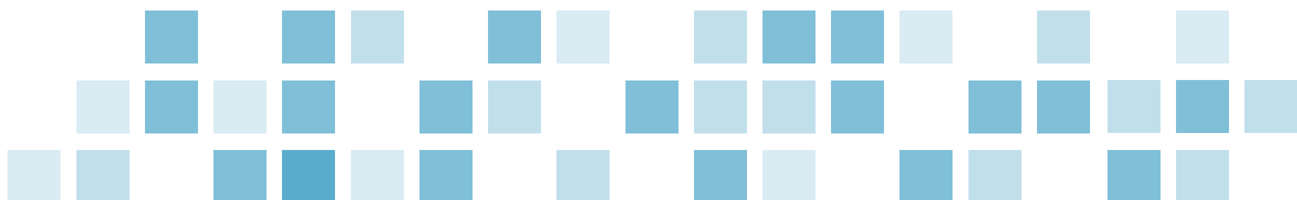
V. Actuarial methods, measurement frequency and valuation requirements

The Entry Age Normal cost method is now required for all plans.

Under Statement 27, employers were allowed to select from six actuarial cost methods to determine the ARC. Use of the level percentage of projected payroll method or the level dollar amortization method were allowed to attribute the unfunded actuarial liability to accounting periods.

Under Statement 68, calculation of the actuarially required contribution is no longer required (however, disclosures are still required for plans that have a legal requirement to fund based on an actuarially determined basis). Statement 68 requires the actuarial present value of projected benefit payments to be attributed to periods of employee service using the entry-age normal actuarial cost method, with each period's service cost determined as a level percentage of pay.

Under Statement 27, an actuarial valuation (AV) should be performed at least biennially. The AV date did not need to coincide with the employer's year end; however, a consistent date was required each year. Additionally, the ARC reported for a fiscal year had to be based on the results of an actuarial valuation performed as of a



date not more than 24 months before the beginning of the employer's fiscal year. For example, when reporting as of Dec. 31, 2012, the AV date could be no earlier than Jan. 1, 2010.

The new requirements under Statement 68 for single employer and multiple employer agent plans, and multiple employer cost sharing plans, are described below.

Single and agent employers

Under Statement 68, there are two dates (or date ranges) to heed — the AV and the measurement date. The AV is performed to measure the total pension liability (present value of projected benefit payments to current active and inactive employees attributable to past periods of service). The AV date can be no earlier than 30 months and one day before the most recent fiscal year-end. Additionally, if the AV date occurs prior to the "measurement date," then the AV has to be "updated." The AV should be performed at least biennially.

Keeping actuarial valuation dates and measurement dates aligned becomes much more complex with multiple employer plans.

Under Statement 68, the "measurement date" indicates when the net pension liability is determined. As a reminder, the *net* pension liability is the *total* pension liability (defined in the paragraph above), less the plan's fiduciary net position. The measurement date can be no earlier than the end of the employer's prior fiscal year, consistently applied from period to period.

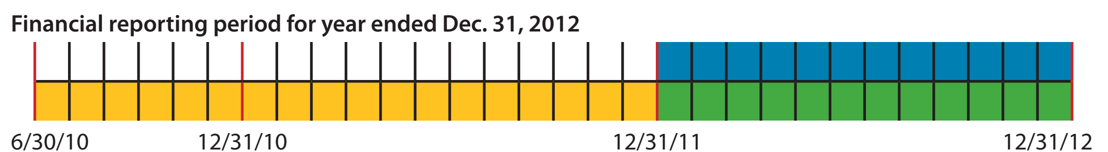
Cost-sharing employers

Similar to single/agent employers, under Statement 68 there are two dates (or date ranges) for cost-sharing employers to heed. The first is the AV date. The AV for the collective total pension liability is performed to measure the present value of projected benefit payments to collective current active and inactive employees attributable to past periods of service. The AV date can be no earlier than 30 months and one day before the most recent fiscal year end (should be determined for each individual reporting employer, as different employers may have different fiscal years). Additionally, if the AV date occurs prior to the measurement date, then the AV has to be updated through the measurement date. The AV should be performed at least biennially.

Use of an actuarial valuation date that coincides with the measurement date will result in less work and more consistent estimates.

Under Statement 68, the measurement date indicates when the net pension liability is determined. For cost-sharing employers, the net pension liability recorded is the employer's proportionate share of the collective total pension liability (defined in the paragraph above), less the plan's fiduciary net position. The measurement date can be no earlier than the end of each employer's prior fiscal year, consistently applied from period to period.

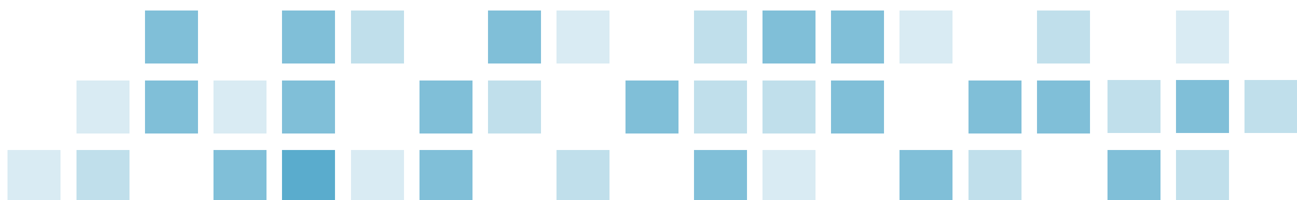
The following graphic displays the various dates for an employer reporting on a Dec. 31, 2012 calendar year.



AV date can be no earlier than June 30, 2010. If a date in the yellow zone is used, it must be updated to the measurement date.

Any date within this horizon is an appropriate measurement date.

If both the AV date and the measurement date are the same and are within this time period, a roll-forward is not required and dates are appropriate.



If the AV date and measurement date do not coincide, beware of significant changes in benefit provisions or assumptions. They could create major changes required in the "update" of the calculation.

As depicted on the previous page, there can be significant time between the AV date and the measurement date, up to 30 months. However, if the AV date precedes the measurement date, the AV calculated *total pension liability* has to be updated through the measurement date. Additionally, if the AV date is in the green zone (for example, Feb. 1, 2012), but precedes the measurement date used (for example, Dec. 31, 2012), the AV calculated *total pension liability* must still be updated to the measurement date.

Other changes and requirements

Statement 68 also discusses these important items:

1. Expanded footnote disclosures provide **more transparency in the assumptions used.**

2. Expanded footnote disclosures also provide more **transparency in the costs of benefits promised**.

Note disclosures will include the impact on the NPL if a discount rate 1 percent higher or lower were used.

3. **New disclosures (and RSI) will track year-to-year liability changes**, with details of the amounts and reasons for the changes, such as

   - Effects of changes in benefit provisions
   - Changes in actuarial assumptions
   - Differences between investment assumptions and actual returns
   - Employer and employee contributions
   - Pension plan income and expenses

4. **New disclosures will present multi-year schedules** displaying balances of deferred outflows/inflows of resources that will be recognized in expense in subsequent years, by year.

5. **Employers and non-employer contributing entities, as well as the plan itself**, will be required to use the same assumptions when measuring pension information.

6. **The projection of benefit payments** (used for calculating the total pension liability) **should include all benefits in force** at the measurement date, including the effects of these automatic benefit changes (and projected ad hoc benefit changes to the extent they are considered to be substantively automatic):

   a. Cost of living adjustments (COLAs)
   b. Ad hoc COLAs
   c. Projected salary changes (per pension formula)
   d. Projected service credits

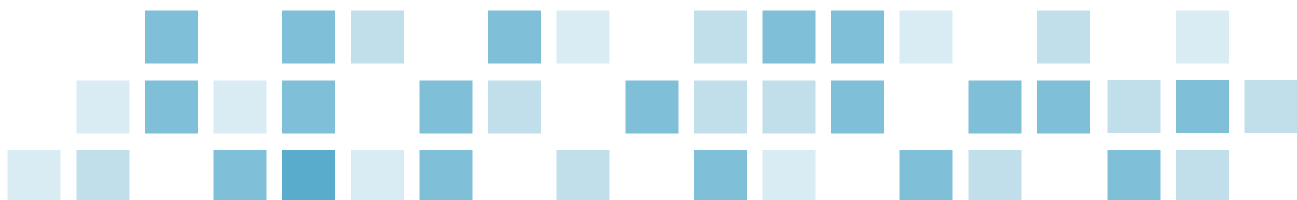
Most of the existing footnote requirements of Statement 27 were retained or expanded.

7. **For cost-sharing employers, disclosures will include:**

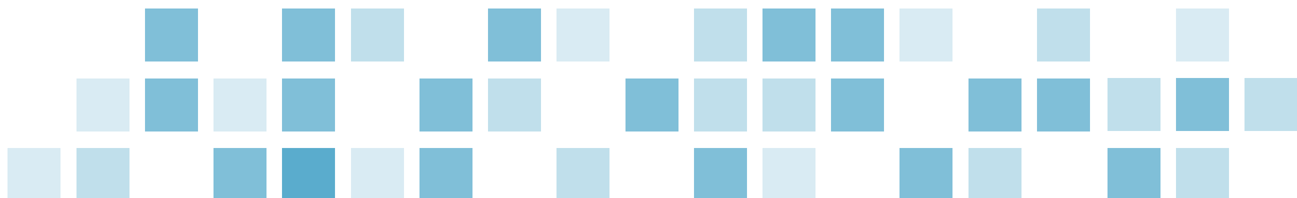
   - Information about the employer's proportionate share of the collective net pension liability
   - Significant assumptions used to determine the collective total pension liability
   - The employer's proportionate share information (amount and percentage, and the basis on which its proportion was determined, as well as any changes since the prior measurement date).

Actions to consider

We suggest giving consideration to the following suggestions for implementing Statement 68. Their early adoption should minimize surprises and allow for a smooth transition.



- **Determine the type of plan you have** (single, agent or cost sharing) and read the corresponding sections of GASB 68. Be sure to review the illustrations in Appendix C.
- **Identify any legal requirements to contribute actuarially determined amounts to your plan(s).** Consider engaging a single actuary to maximize efficiencies and minimize costs.
- **Establish the measurement date.** If the AV can be performed on the same date, a roll-forward of the actuary's calculation will not be necessary. This should be a simple matter for most single-employer plans, but is not as simple for multiple-employer plans.
- **A plan's net position is an important component of the net-pension liability.** Be sure to consider the expected issuance date of the plan's financial statements when selecting the measurement date.
- **For multiple-employer plans, hold a meeting of the employers and the plan's administrator** to discuss the timing and frequency of the AV and how (and when) information will be disseminated to each employer. For cost-sharing plans, determine the method to be used for calculating proportionate shares. If the AV date is before the measurement date, discuss how an individual employer can obtain sufficient detail for an independent roll-forward of the calculation (unless this will be provided by the administrator).
- **If the measurement date and AV date will not coincide, determine who will perform the necessary roll-forward**. This calculation is a significant estimate, and major changes since the original valuation date could have a material impact. If the auditor is unable (or unwilling) to perform this work, there may be a need to engage another actuary to update the original valuation.
- **Meet with plan officials to develop the same assumptions for both plan and employer reporting**. Agreeing to the assumptions in advance will help eliminate inconsistencies and should reduce the need for involved actuaries to re-calculate data.
- **Cost-sharing plan participants should understand the contribution requirements**, as they will have a significant impact on the "proportionate share" of the liability being recorded. Determine the frequency and how cost-sharing allocations will be reviewed. Communicate any concerns early in the process.
- **Meet with the governing body to discuss key issues:** the new standard's requirements, the expected impact on net position, the significant assumptions selected by management, and the level of involvement of other entities (e.g. governments or plan administrators). In situations where there may not be a corroborative spirit between all involved entities, it may be necessary to have members of the governing body intervene.
- **Know the consequences of underfunding**. The rating agencies and other users of financial statements will notice a significantly underfunded plan. Be prepared to discuss with the governing body the impact that a significant underfunding may have. A rating decrease, for example, would likely increase the borrowing rate, making debt issuances less affordable.
- **Meet with the actuary early in the process** to make sure that he or she is aware of the requirements of both Statements 67 and 68. Determine what will be needed in order to perform a timely and accurate actuarial valuation; discuss deadlines for both parties.
- **Meet with the auditor to discuss the implementation plan.** Determine the auditor's required documentation and support. Provide information about the actuary's qualifications and professional reputation – or include the actuary in the meeting. Consider allowing the auditor to evaluate the significant assumptions to be used, particularly the long-term RoR on investments, before the actuary finalizes the calculation.
- **There are also new group audit standards that may have an impact on adoption of this statement.** If the employer's auditor will not be auditing the plan, determine in advance the communication and interaction that the firm will need to have with the plan auditors (and plan management).



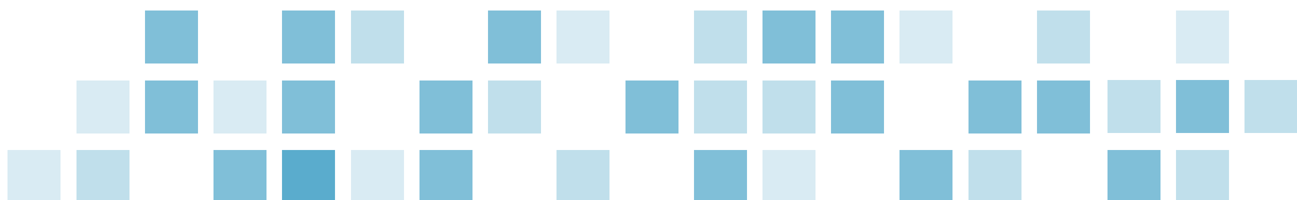
- **Draft the new footnotes and required supplementary information.** This will likely be a time-consuming task. If the auditor or an independent consultant will prepare this information, discuss what details they will need, timing, the assistance they can seek from the actuary, and any concerns pertaining to these non-audit services.

Conclusion

The provisions of Statement 68 are numerous and their implications important to understand. Keep in mind that this article is not a substitute for reading the statement in its entirety. There are numerous details in the statement that are not addressed here.

Reading the statement is vital for fully understanding its impact on an organization. Then meeting with key parties, including the auditor and actuary – as well as other employers for multiple-employer plans – early in the process will help ensure a smooth transition with limited surprises.

With the heightened attention that rating agencies and other parties are now paying to governmental financial statements, ensuring that Statement 68's new requirements are appropriately incorporated will bring peace of mind to an organization's governing body and all of its stakeholders.



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