Illinois Government Finance Officers Association
Technical Accounting Review Committee

Summary of Discussion April 17 and May 8, 2009
Invitation to Comment - Pension Accounting and Financial Reporting

Overview

Two concerns were discussed in relation to current accounting standards:

- Transparency for plan changes, especially benefit increases.

- Volatility as it relates to annual required contributions and to expense recognition for budget purposes.

Chapter 2: Focus of Accounting and Financial Reporting for Pensions

Respondents are asked:

To best achieve financial reporting objectives of accountability and decision usefulness, including the assessment of interperiod equity, which of the following processes related to pensions do you believe governmental accounting and financial reporting should provide information about, and why?

a. The process by which an employer incurs and obligation to employees for defined pension benefits earned by them

b. The process by which an employer finances its projected future cash outflows for defined pension benefits

c. Both processes?

The Committee believes the employer's liability to employees for unfunded pension benefits that employees have earned needs to be more transparent to the decision makers for employee compensation and benefit increases. Reporting the liability provides a better measure of the pension cost than focusing on the periodic contributions as actuarially determined.

However, using the annual employer contribution calculated for funding purposes as the basis for expense measurement is reflective of the enduring nature of state and local government sponsors and results in a measure of annual pension cost over time that reflects a systematic more stable allocation of total projected costs.

Therefore reporting that provides information on both processes would be beneficial.

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Chapter 3: Issues Related to Liability and Expense Recognition

Respondents are asked:

What obligations of a sole or agent employer associated with pensions meet the definition of a liability in Concepts Statement 4, and why?

a. A measure of the cumulative difference between (1) amounts expensed, based on annual required contributions of the employer to the pension plan pursuant to a program of funding pension benefits developed within established parameters and (2) the amounts the employer actually has contributed to the plan

b. A measure of the employer's unfunded accrued benefit obligation to employees at the financial report date related to the employment agreement governing the exchange of employee services for salaries and benefits

c. Other.

The Committee is concerned that alternative a. which does not recognize the effects of transactions that affect the liability (unfunded accrued benefit obligation) each period as they occur, results in incomplete accountability for changes that may significantly increase an employer's total obligations and the financial burdens on future taxpayers. For example benefit changes that are applied retroactively to increase compensation for past periods of service. Additionally, alternative a. misattributes past service costs to future periods that do not benefit from them which is inconsistent with the concept of attributing costs to financial reporting periods on an interperiod-equity basis. As was indicated in the overview, the Committee feels greater transparency is needed. Therefore the Committee is in favor of alternative b. for recognition of a liability.

Which of the following expense recognition patterns do you believe is more consistent with the concept, in paragraph 27 of Concepts Statement 4, that applicability to a reporting period or periods for purposes of expense recognition in government-wide, proprietary fund, and fiduciary fund financial statements should be determined based on the notion of interperiod equity, and why?

a. Recognition of the effects of transactions and other events that affect the unfunded accrued benefit obligation as they occur each year

b. Deferred recognition (deferral and amortization) of some or all components of pension cost other than normal cost over a number of future years determined by an employer or by plan trustees within accounting parameters.

Given the Committee's concern on volatility of annual required contributions and expense recognition (recognition at the entity-wide level will not affect budget concerns) alternative b. provides some flexibility in expense recognition. However the constraints should be clearly defined so as to be consistently applied.

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Chapter 4: Approaches to Measurement

Respondents are asked:

Should the projection of pension benefits include or exclude the following projected future changes? Why?

a. Automatic COLAs
b. Projected future ad hoc COLAs, in circumstances in which ad hoc COLAs are substantively a part of the employment agreement, as demonstrated by an employer's pattern of practice
c. Projected future salary increases
d. Projected future service credits.

The Committee believes automatic COLAs should be included in the projection of pension benefits because employees exchange their services for an overall compensation package that includes pension benefits with the automatic COLA provision, therefore automatic COLAs are part of employment exchange transactions that already exist.

Likewise, the Committee believes ad hoc COLA increases for which the government has demonstrated through past practice that the COLAs are substantively a part of the plan should also be included in the projection of the pension benefits. The Committee is concerned that to exclude such COLA increases would lead to potential manipulation of the liability on the part of the government. However the Committee believes specific guidelines or defined parameters should be provided in the final pronouncement for when ad hoc COLA increases are "substantively a part of the plan".

In considering future salary increases and future service credits the Committee supports the view that the focus of financial reporting should be on the process by which employees earn pension benefits and that the employer incurs an obligation for benefits earned by virtue of the plan and the services rendered to date. Therefore the measurement of the obligation should reflect only transactions and other events that have occurred to date and should not include future salary increases that are unearned. Similarly the Committee would support the inclusion of future service credits only to the extent that the minimum benefit provision is included unless a benefit above the minimum level has been earned to date.

This approach however would be in conflict with the Committee's goal to achieve greater transparency for plan changes, especially benefit increases, as the impact of those changes would be mitigated by an approach which does not take into account future salary increases and future service credits. An approach however that recognizes the liability at the greater amount with recognition of an asset for deferred outflows that relate to future salary increases and future service credits would provide greater transparency for plan changes with an offset to reduce that obligation to include only services rendered to date.

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Chapter 4: Approaches to Measurement – Cont.

Respondents are asked:

What should be the basis for determining the discount rate used for discounting projected pension benefits to their present value for accounting purposes? Why?

a. The estimated long-term investment yield for the plan
b. A risk-free rate (or a yield curve of risk-free rates applied to cash flows of different maturities)
c. The employer's borrowing rate
d. An average return on high-quality municipal bonds
e. Other.

While the estimated long-term investment yield for the plan reflects the plan's pattern of investing and the plan's ability to accumulate interest it does not take into account a consistent pattern of not funding or underfunding the annual required contribution (ARC) on the part of the employer, i.e. the rate does not reflect the credit risk of the employer as plan sponsor. While the employer's borrowing rate does reflect an adjustment for the employer's own credit risk, because it is based on the perceived likelihood that the employer will repay its obligations, it does not involve considerations related to investing patterns or assumptions about future investment policy and experience.

The Committee therefore recommends a blended rate of estimated long-term investment yield for the plan and the employer's borrowing rate based on the percent or extent to which the employer has funded the annual required contribution. This would be consistent with GASB Statement No. 45 paragraph 13 c. "…the investment return assumption (discount rate) should be the estimated long-term investment yield on the investments that are expected to be used to finance the payment of benefits, with consideration given to the nature and mix of current and expected investments and the basis used to determine the actuarial value of assets. For this purpose, the investments expected to be used to finance the payment of benefits are (1) plan assets for plans for which the employer's funding policy is to contribute consistently an amount at least equal to the ARC, (2) assets of the employer for plans that have no plan assets, or (3) a combination of the two for plans that are being partially funded. The discount rate for a partially funded plan should be a blended rate that reflects the proportionate amounts of plan and employer assets expected to be used."

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Chapter 5: Issues Related to the Use of Actuarial Methods

Respondents are asked:

If, after due process, the accounting measurement approach adopted by the Board for pensions were to be one of those discussed in Chapter 4 that includes the amortization of some components of pension cost for purposes of recognition of an employer's pension expense:

a. Which *actuarial cost method or methods* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?

The Committee believes the number of cost methods currently permitted reduces comparability, introduces a subjective element and makes the ability to interpret the financial statements unduly complex. The Committee is in favor a single acceptable method and would support the use of the entry age method based upon the preponderance of governments that currently utilize this method.

b. What should be the *maximum amortization period or periods* permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?
c. Should *different maximum amortization periods* be set for different types of changes to the unfunded accrued benefit obligation? Why or why not?
d. If you answered yes to Question 6c, what should be the *maximum amortization period* for *benefit changes applied retroactively to past periods of service* that were not substantively a part of the employment agreements that established the compensation for services in those periods or were not previously included in the projection of pension benefits? What should be the maximum amortization *period for actuarial gains and losses*? Why?
e. Which amortization method or methods should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?

The Committee believes different maximum amortization periods for different components of pension cost other than normal cost would more accurately reflect the nature of the different components and the government's ability to influence changes made to those components. Retroactively applied benefit increases for members already receiving a benefit should be recognized immediately as there is no future service to be provided, and for active members should be recognized over the average remaining service life of active plan members. This treatment is consistent with maintaining interperiod equity and the Committee's objective of greater transparency for plan changes especially benefit increases. The Committee would support a longer amortization period for actuarial gains and losses to level short-term experience and reduce volatility. The Committee favors the use of open-period amortization because it avoids the abrupt changes that could occur in the amounts of expense recognized in closed period amortization as the individual components of pension cost are fully amortized and because it is consistent with the long-term going concern nature of governments. The Committee believes a thirty year period is too long for open-period amortization and favors a mandated rolling (not variable) twenty year period. The Committee believes a shorter amortization period, not to exceed 10 years, should be utilized for changes to the actuarial assumptions when the employer has significant influence over the choice of assumptions utilized.

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Chapter 5: Issues Related to the Use of Actuarial Methods – Cont.

f. What method or methods of determining the *actuarial value of plan assets* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?

The Committee believes the employer's pension obligation should be reported a fair value at the financial report date but would support the recognition of a deferred expense to reduce volatility in measuring annual pension cost. The Committee would support a five-year smoothing period for determination of the annual pension cost.

Chapter 6: Accounting by Employers in Cost-Sharing Plans

Respondents are asked:

Does the relationship between a cost-sharing employer and the cost-sharing multiple-employer plan in which it participates *differ enough in economic substance* from the relationship that sole or agent employer has with the plan in which it participates *to support different requirements with regard to liability and expense recognition?* Which of the following views best represents your view, and why?

a. The relationship does differ in economic substance, and current measurement, recognition, and disclosure requirements appropriately account for the pension cost and obligation of an employer in a cost-sharing plan.

b. The relationship does differ in economic substance, and current measurement and recognition requirements are appropriate; however, additional disclosures by cost-sharing employers are needed.

c. The relationship does not differ in economic substance; a cost-sharing employer has a long-term pension obligation based on the employment exchange and should measure and recognize its obligation and expense in a manner similar to that for sole and agent employers.

The relationship does differ, but only when the cost-sharing employers lack any control over the plan (i.e. the plan is dictated by state law). In this case, the state should own the liability which it created and hence there would be a difference in economic substance from that of a sole or agent employer. If there is no higher entity controlling the cost-sharing plan and the liability essentially falls to the employer, then the relationship does not differ in economic substance to that of a sole or agent employer.

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Chapter 7: Issues Specific to Reporting by Plans

Respondents are asked:

Which of the following should a pension plan report as its liability in regard to pension benefits, and why?

a. A liability for benefits currently due and payable
b. The accrued benefit obligation, however measured.

The Committee does not support reporting the accrued benefit obligation as it is not an obligation of the plan but is rather an obligation of the employer and would therefore report only a liability for benefits currently due and payable.

Should a presentation of changes in the unfunded accrued benefit obligation be a required part of general purpose financial reporting? Why or Why not?

a. If yes, which financial report(s) should contain that presentation: the employer's, the plan's, or both? Why?
b. If yes, should the presentation be a basic financial statement, a note to the basic financial statements, or required supplementary information? Why?

To support greater transparency in changes in the unfunded accrued benefit obligation the Committee believes a presentation of changes should be required for both the employer and the plan. The Committee supports a presentation which reports the changes based upon who has control over the change, for example asset changes over which the employer may have no control vs. changes in actuarial assumptions over which the employer does have control vs. benefit changes that may be mandated by another level of government. The Committee recommends note disclosure for current year changes and six-year trend information as required supplementary disclosure.

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Example Adjustments at Entity-Wide Level

Account	Adjustment	
Assets		
Actuarial Value of Assets		
@ Market Value on Report Date	Debit #1	
Deferred Outflows		
Reduction of AAL to Exclude Salary Increases		
& Future Service Credits	Debit #2	
Deferred Expense		
Adjustment to Actuarial Value of Assets		
to 5 Year Smoothing	Debit #3	
Liabilities		
Actuarial Accrued Liability (Entry Age Method)		
Including - COLAs, Substantive COLAs,		
Salary Increases & Future Service Credits		Credit # 1
Expense		
Annual Required Contribution	Debit #1	Credit # 2
Including -		Credit # 3
Beneficiary Retro Benefit Increases @ Immediately		
Active Retro Benefit Increases @ Average		
Remaining Service Lifes		
Actuarial Gains & Losses @ 20Years Rolling/Open		
Change in Assumptions @ 10 Years		