CHEIRON CLIENT ADVISORY

Fall 2011 Vol. 8 No. 4

GASB 27 Exposure Draft on Employer Accounting and Financial Reporting for Pensions: A Detailed Advisory

Introduction

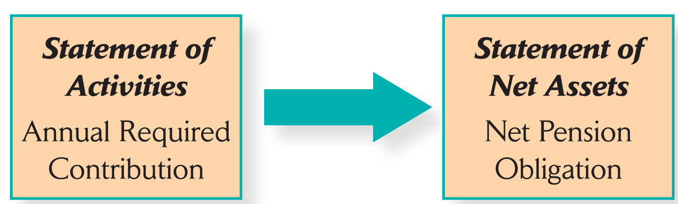
On July 8, 2011, the Governmental Accounting Standards Board (GASB) released exposure drafts of proposed amendments to Statements 25 and 27 covering the pension accounting and financial reporting for employers and pension plans. Cheiron issued an Alert providing a brief overview of the exposure drafts.[1] Subsequently, we issued an Advisory providing a more detailed analysis of the financial reporting requirements for pension plans under GASB 25. This Advisory is intended to provide a more detailed analysis of the GASB 27 exposure draft and the changes to employer accounting and financial reporting for pensions.

The exposure drafts are the next step in the process of changing GASB Statements 25 and 27.[2] The proposed effective date is for reporting periods beginning after June 15, 2012 for employers with single employer plans and assets of $1 billion or more in the **plan's** first fiscal year ended after June 15, **2010**. For example, for a single employer plan with a plan year and employer fiscal year beginning July 1 and with assets of $1 billion or more on June 30, 2010, the effective date would be the fiscal year beginning July 1, 2012. For all other employers, the proposed effective date is for financial statements for periods beginning after June 15, 2013.

Philosophical Change

The proposed standards represent a significant change in the structure of employer accounting for public pension plans. The most important aspect of this change is the divorce of accounting from funding.

Under current standards, the employer's annual pension expense shown in their Statement of Activities (a.k.a. the income statement) equals the Annual Required Contribution (ARC) adjusted for years when the full ARC wasn't contributed. The liability shown on the Statement of Net Assets (a.k.a. the balance sheet), the Net Pension Obligation (NPO), was essentially the accumulated difference between the ARC and actual contributions. Consequently, the focus for pension accounting was on the ARC and whether or not actual contributions were equal to the ARC.

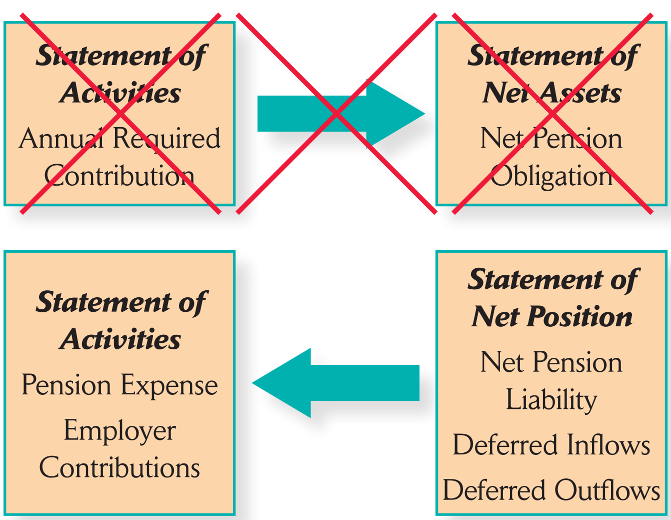


[1]https://www.cheiron.us/cheironHome/viewArtAction.do?artID=76

[2]In 2009, GASB issued an Invitation to Comment on pension accounting and financial reporting, and in 2010, GASB issued its Preliminary Views.

As a result of this structure, the ARC became a de facto national funding standard for public pension plans. GASB was clearly uncomfortable with its accounting standard being referred to as a funding standard. "It is not within the scope of the Board's activities to establish standards with regard to a government's method of financing the benefits it has obligated itself to provide (that being a policy decision for government officials or other responsible authority to make) or to regulate a government's compliance with the financing policy or method it adopts (par. 128)." The ARC has been eliminated from GASB's lexicon, and the focus for pension accounting has shifted to the balance sheet, now called the Statement of Net Position.

The annual pension expense is no longer an amount that might be contributed to the pension plan following a long-term level-cost funding strategy. Instead, it is the difference between the employer's net position at the beginning of the year and the employer's net position at the end of the year as it relates to the pension plan.



The balance sheet also contains some new items. The Net Pension Liability (NPL) is essentially the Unfunded Actuarial Liability (UAL) based on the market value of assets. Details of its calculation are discussed in our advisory on GASB 25. Deferred Inflows are actuarial gains and Deferred Outflows are actuarial losses that are recognized over future accounting periods. The development of the Deferred Inflows and Outflows is discussed in detail below.

The other major change in employer accounting is that all of these disclosures must be as of each employer's fiscal year end even if the plan's reporting year end may be different. For large, multiple employer systems (including cost-sharing systems), disclosures are likely required to be developed as of multiple dates to cover all of the employers' fiscal year ends.

Recognition of Changes in Net Pension Liability

The change in Net Pension Liability (NPL) from the beginning of the year to the end of the year is recognized over time in the employer's pension expense. Changes in the NPL come from the following sources:

- Service cost,
- Interest on the Total Pension Liability,
- Projected earnings on plan investments,
- Employee and employer contributions,
- Investment gains and losses,
- Other actuarial gains and losses (i.e., the difference between actual experience and assumed experience),
- Changes in actuarial assumptions and methods, and
- Changes in plan benefit provisions.

Some of these items are recognized immediately and others get deferred recognition.

Immediate Recognition

The normal operating and financing activities are recognized immediately as a part of the annual pension expense including:

- Service cost,
- Interest on the Total Pension Liability,
- Projected earnings on plan investments, and
- Employee and employer contributions.

In addition, any changes in plan benefit provisions are recognized immediately as are any changes in the Total Pension Liability for *inactive* members due to changes in assumptions and methods or due to other actuarial gains or losses.

Deferred Recognition of Investment Gains and Losses

Investment gains and losses are recognized over a five-year period "using a systematic and rational method."

The simplest approach is to just compare expected earnings to actual earnings for the period and divide by five. This amount would be recognized each year for five years beginning with the current fiscal year.

Note that the expected earnings will vary depending on actual contributions and actual benefit payments during the year. So, this calculation cannot be performed until after the fiscal year when actual earnings are known and expected earnings can be calculated.

Deferred Recognition of Other Changes in Active Member Liability

For assumption changes or actuarial gains or losses related to active members, the change in total pension liability is recognized "using a systematic and rational method" that approximates what "would be obtained if such changes in each active employee's total pension liability were recognized separately over that employee's expected remaining service life" (Par. 28a(4)(b)).

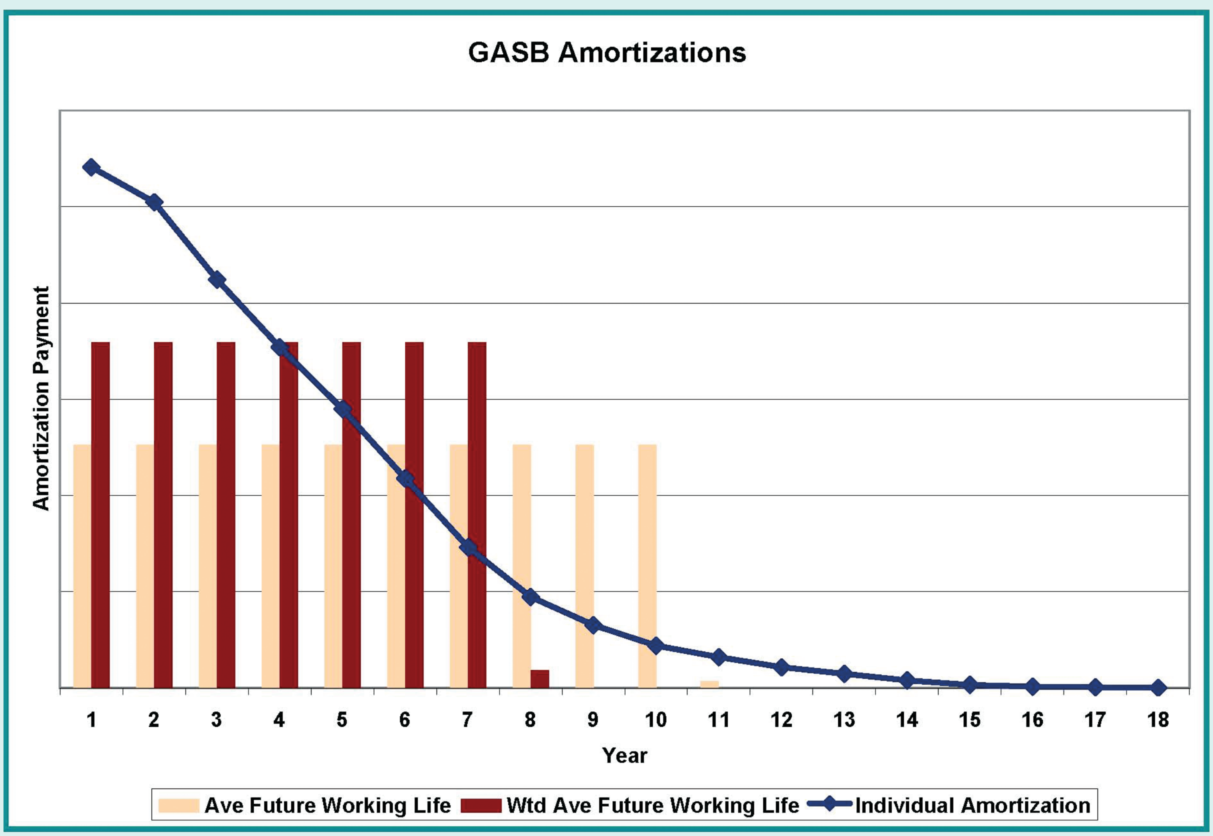
The table below summarizes the period over which gains and losses are recognized in pension expense.

Method of Deferred Recognition

The chart below illustrates the recognition pattern that would have been produced if the gain or loss for each individual active employee is recognized over that individual employee's expected remaining service life in a straight line. In comparison, the dark red bars

Recognition Periods for Pension Expense

Change	Active Members	Inactive Members
Investment gain or loss	5 years	5 years
Actuarial gain or loss	Expected working lifetime	Immediate
Actuarial assumption or method	Expected working lifetime	Immediate
Plan benefit provisions	Immediate	Immediate



show a straight line recognition of the aggregate loss over the average remaining service lives weighted by the size of the individual gain or loss, and the tan bars show a straight line recognition over the average remaining service life (unweighted).

It is not clear from the Exposure Draft how closely the blue line should be approximated, but it seems unlikely that the amortization methods traditionally used for funding would be acceptable. As noted above, the interest on these amounts is already accounted for as part of the interest cost on the total pension liability. So, the recognition amounts shown above just represent the recognition of principal (not interest). A typical level percent of pay amortization used in funding would exhibit a pattern that is the opposite of the blue line. That is, very little principal (if any) would be recognized in the early years of the period, and each year a larger share of the principal would be recognized until the entire amount is recognized.

Straight line methods of recognition as shown in the chart are more likely to be acceptable, but they also don't follow the pattern of the blue line very closely.

Employer's Net Position

An employer's Net Position is simply assets plus deferred outflows less liabilities less deferred inflows. The table below illustrates the layout of an employer's statement of net position and the pension plan entries in each section of the statement.

Employer's Statement of Net Position
Assets
No pension plan entries
Deferred Outflows of Resources
Unrecognized Actuarial Losses
Liabilities
Net Pension Liability
Deferred Inflows of Resources
Unrecognized Actuarial Gains
Employer's Net Position

Under the Exposure Draft for Statement 27, there is no specific disclosure that shows the pension plan's contribution to the employer's net position. It can be calculated by subtracting the pension plan's Net Pension Liability and Deferred Inflows from the pension plan's Deferred Outflows.

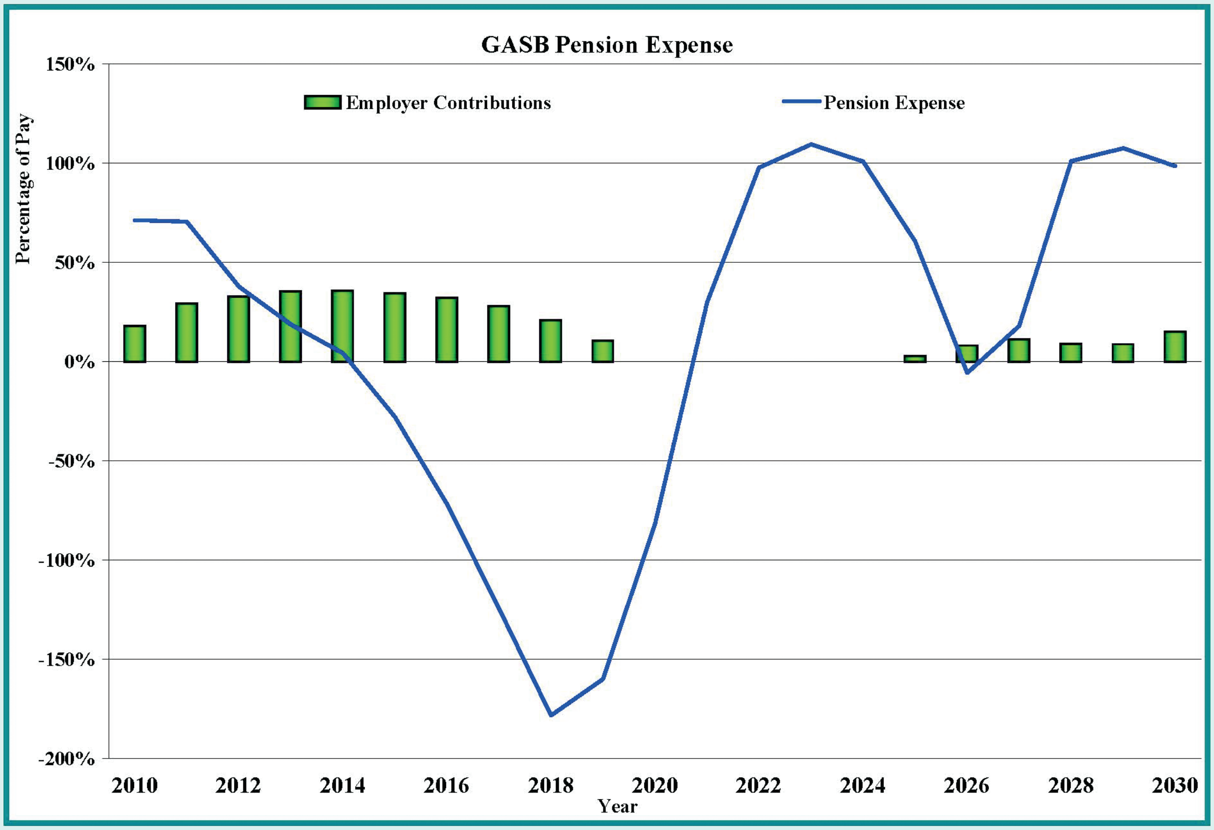
Cheiron Observation: *Because the NPL is clearly identified on the balance sheet, there will be a temptation for the user to think the NPL represents the pension plan's impact on the employer's net position. We recommend doing the arithmetic of adjusting the NPL for deferred inflows and outflows to disclose the employer's net position related to pensions.*

Pension Expense

An employer's pension expense is the employer's net position related to pensions at the end of the fiscal year minus the employer's net position related to pensions at the beginning of the employer's fiscal year plus employer contributions during the fiscal year. In the past, the pension expense could be interpreted as the annual cost to fund the pension plan, but now, it is a balancing item to reconcile the change in the employer's net position as it relates to the pension plan. The interpretation of pension expense may not be immediately clear, but it is not an amount that plans are likely to use for funding. The chart below shows the projected volatility of the pension expense compared to a contribution policy based on 20-year layered amortizations[3] and repeating the investment returns of the last 20 years.

Cheiron Observation: *In the past, the pension expense was known well in advance of the fiscal year. But, under the proposed standards, it will be impossible to know the pension expense until after the fiscal year closes. The NPL reflects the market value of assets as of the end of the fiscal year. In order for the pension expense to reconcile the changes in the employer's net position related to pensions it cannot be calculated until the market value of assets and all transactions affecting projected investment earnings are known.*

[3] The actuarial gain or loss, plan amendments, and assumption changes recognized each year are amortized over closed 20-year periods as a level percentage of payroll.



While the aggregate pension expense may be difficult to interpret, the components of pension expense have intuitive meanings. The table below groups the components of expense (using GASB's Illustration #2) to make those meanings clearer for the user to understand.

Pension Expense

Operating Activities		
Service cost	$	101,695
Current-period benefit changes		-
Member contributions		(51,119)
Administrative expenses		3,427
Total	$	54,003
Financing Activities		
Interest on the total pension liability	$	231,141
Projected earnings on plan investments		(178,268)
Total	$	52,873
Recognition of Investment (Gains) or Losses		
Current year (gains) or losses	$	(4,201)
Prior years (gains) or losses		41,126
Total	$	36,925
Recognition of Liability (Gains) or Losses		
Current year (gains) or losses	$	(37,579)
Current year assumption changes		-
Prior years (gains) or losses		(320)
Prior years assumption changes		15,915
Total	$	(21,984)
Total Pension Expense	$	121,817

Operating Activities

The operating activities represent the cost of administrative expenses and employer-paid benefits attributed to that year by the entry age normal cost method. This can be thought of as the estimated cost of the services during the period.

Financing Activities

The financing activities represent the interest cost on the unfunded actuarial liability. If a plan is 100% funded, the interest cost on the total pension liability will equal the projected earnings on plan investments. If the plan is not 100% funded, there is a cost for the interest on the portion that is unfunded.

Cheiron Observation: *In order to fully fund a pension plan, contributions over periods of time should generally exceed the sum of the operating and financing costs shown above. If contributions are consistently less than this benchmark, the plan will need to hope for actuarial gains to achieve full funding.*

Investment Gains and Losses

This section of the expense illustrates the current recognition of gains and losses that are recognized over a five-year period. In theory, the investment gains and losses will balance out over time.

Liability Gains and Losses

This component of the expense illustrates the current recognition of gains and losses and assumption changes. The current year items include the immediately recognized gains and losses on inactive members as well as the portion of the gains and losses on active members that is recognized in the current year. The items for prior years show the net amount of gains and losses due to active members in prior years that are recognized in the current year. In theory, these amounts should balance out over time.

Note Disclosures and Required Supplementary Information

The Preliminary Views provided no indication of the disclosures that might be required in the Notes to the Financial Statements and in the Required Supplementary Information. The exposure drafts create new schedules and extend the period of most of the schedules from the current six years to a proposed 10 years.

Because each of the schedules must be provided for each employer as of that employer's fiscal year end, the additional schedules may increase administrative expenses, especially for large multiple employer plans (including cost sharing plans) where the employers may have different fiscal year ends.

In a large multiple employer plan, the schedules will require total pension liability to be projected to each employer's fiscal year end, assets to be reported and allocated to employers for each employer's fiscal year end, actual and expected investment earnings as of each employer's fiscal year end, amortization periods to be determined at each employer's fiscal year end, covered payroll to be determined at each employer's fiscal year end, etc. For plans with employers with different fiscal year ends, the task of providing all of these schedules could be significant, requiring additional work from the plan's staff, the plan's actuary, the plan's auditor, and each employer's auditor.

Next Steps

Retirement systems and employers participating in a retirement system may want to review the details of the exposure drafts to determine the potential impact on their financial statements and the potential cost of complying with these proposed requirements. The accounting standards do not change any requirements for funding unless the statutes governing the retirement system explicitly refer to the accounting standards, so contributions for the vast majority of systems should be unaffected.