



Q&A GASB'S NEW PENSION STANDARDS: SETTING THE RECORD STRAIGHT

The Governmental Accounting Standards Board's (GASB) recent pension standards substantially improve the accounting and financial reporting of public employee pensions by state and local governments. The new standards are:

- Statement No. 67, *Financial Reporting for Pension Plans*, which applies to financial reporting by most pension plans.
- Statement No. 68, *Accounting and Financial Reporting for Pensions*, which applies to financial reporting by most governments that provide their employees with pension benefits.

Below are questions and answers that should help clarify common misperceptions about the new pension Statements.

1 DO THE NEW GASB STATEMENTS ESTABLISH REQUIREMENTS FOR HOW GOVERNMENTS SHOULD FUND THEIR PENSIONS?

No. In the past, the accounting and financial reporting standards were closely associated with the approach that many governments take to funding their benefits—that is, toward contributing sufficient resources to a defined benefit pension plan to finance benefit payments when they come due. Consequently, many governments have established funding policies based on the GASB's standards. However, after reexamining the prior standards for pensions, the GASB concluded that approaches to funding are not necessarily the best approach to accounting for and reporting pension benefits. Therefore, the new Statements mark a definitive separation of accounting and financial reporting from funding.

2 WILL GOVERNMENTS HAVE TO PAY MORE EACH YEAR FOR PENSIONS BECAUSE OF THE GASB'S NEW STATEMENTS?

As just stated, the new pension Statements relate only to accounting and financial reporting, or how pension costs and obligations are measured and reported in external financial reports. How much governments actually contribute each year to a pension plan is a policy issue. Governments will likely report pension expense more quickly than under the prior standards; however, how or whether this information is used in assessing the amounts that governments will contribute to their pension plans is a public policy decision made by government officials.

3 DO GOVERNMENTS HAVE TO USE A MUNICIPAL BOND RATE FOR DISCOUNTING AS PUNISHMENT FOR NOT FULLY FUNDING THEIR PENSIONS?

No. The selection of an appropriate interest rate for discounting projected future benefit payments to their present value is based on what resources are projected to be used to make those payments: (1) assets of the plan that have been invested using an investment strategy to achieve the assumed long-term expected rate of return and their earnings; or (2) the general resources of the government employer. As long as the projected plan net position related to current employees and inactive employees exceeds the projected benefit payments for those employees, the long-term expected rate of return on investments will serve as the basis for discounting. This asset-based rate is appropriate because the earnings on the plan's investments reduce the amount an employer will need to contribute to the plan.

If a government reaches a *crossover point*—when projected benefit payments for current employees and inactive employees exceed projected plan net position related to those employees—then benefit payments projected to be made from that point forward will be discounted using a high-quality municipal bond interest rate. This liability-based rate is appropriate because the plan would no longer be expected to have sufficient assets related to those employees to produce investment income that will reduce how much an employer will have to contribute. The pension liability would then resemble the employer's outstanding debt and other typical long-term liabilities.

However, it is true—all other factors being equal—that the less well-funded a pension plan is, the more likely it will reach a crossover point and therefore have to discount some projected benefit payments using the municipal bond index rate. Under current economic conditions, municipal bond rates are lower than long-term expected returns on pension plan investments. Using a lower discount rate increases the present value of projected benefit payments and, thereby, increases the size of the pension liability.

4 DO THE GASB'S STANDARDS ALLOW GOVERNMENTS TO MAKE THEIR LIABILITIES LOOK SMALLER BY USING A DISCOUNT RATE BASED ON UNREALISTICALLY HIGH EXPECTED RATES OF INVESTMENT RETURN?

No. The new Statements require that governments measure their pension liabilities using assumptions that are consistent with the standards of practice of the actuarial profession. If a government assumes a rate of return that is out of line with the actuarial standards, then it is misapplying the accounting standards rather than exploiting a loophole in the standards.

It is important to note that examining a pension plan's investment return in any short-term period is not appropriate for drawing conclusions about the appropriateness of a government's assumption about *long-term* investment earnings. The investment return in any given year or short-term period is likely to be either higher or lower than the assumed long-term return. However, an appropriate long-term investment return assumption will reflect the expected average earnings over a long period, even though

it may not be the same as actual earnings in any particular single or short-term period.

Governments will disclose information about their long-term investment return assumptions in the notes to the financial statements to assist in evaluating the reasonableness of those assumptions. The information will include a brief description of how the long-term expected rate of return was determined, significant methods and assumptions used for that purpose, the assumed asset allocation of the pension plan's portfolio, and the long-term expected real rate of return for each major asset class.

5 IS THE DISCOUNT RATE THE MOST IMPORTANT FACTOR IN DETERMINING THE SIZE OF A GOVERNMENT'S PENSION LIABILITY?

The guidance put forth in the new Statements pertaining to the selection of a discount rate is certainly an important element but it is only one part of the determination. Discounting is one of the basic three steps involved in measuring a government's total pension liability—projecting, discounting, and attributing. (The measurement process is more fully described in separate fact sheets about accounting and financial reporting by governments that provide pension benefits.)

The amount of a government's pension liability also depends on a variety of other factors such as:

- The types of benefits a government has promised
- The length of service of employees and their salaries in the final years of their employment
- The life expectancy of retirees, which determines how long they will continue to receive benefits
- The inflation rate, which affects both salaries and rates of return on investments.

6 CAN THE INFORMATION REPORTED BY GOVERNMENTS UNDER THE NEW STATEMENTS BE COMPARED?

Yes. The comparability of the pension information that will result from the new Statements has been significantly improved. One of the features of the prior standards that many financial statement users have criticized is the variety of choices that employers could make when attributing the present value of

projected benefit payments to past, present, and future periods. Governments previously were allowed to select from six different actuarial cost allocation methods, each of which could be applied in two ways—as a level dollar amount each year or as a level percentage of payroll in each year. In the view of many users, these options seriously diminished comparability. The new Statements, however, require that all governments use one type of actuarial cost method—called *entry age*—and apply it only as a level percentage of payroll.

It should be noted that, although governments are required to measure their pensions within the same parameters set forth in the standards, the resulting amounts will be different because of differences in the terms of the governments' respective pension plans, differences in the demographics of the plan members, and differences in other relevant factors. In other words, because the governments are in different circumstances, their measurements will employ different assumptions.

It has been suggested that comparability would be greatly improved if all governments were required to use the same assumptions. However, taking a one-size-fits-all approach would ignore significant differences between governments—such as the mix of their investment portfolios and their actual earnings experience—that are relevant to determining the amount that governments are obligated to provide for pensions.

7 HAS THE GASB DETERMINED THAT STATE AND LOCAL GOVERNMENT PENSION PLANS ARE UNDERFUNDED BY \$3 TRILLION?

No. The GASB has never conducted research regarding the extent to which pension plans are funded in the aggregate. Funding relates to a public policy issue that is beyond the scope of the GASB's activities.



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