

## **Staff Report on Governmental Accounting Standards Board Statements 67 and 68**

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### **Summary**

On June 25<sup>th</sup>, 2012, the Governmental Accounting Standards Board (GASB) approved two new standards relating to financial reporting for state and local defined benefit plans and defined contribution plans. According to GASB, the objective of the new Statements is to improve financial reporting by state and local governmental pension plans. The standards were made available for download on August 3<sup>rd</sup>, 2012.

#### ***Statement No. 67, Financial Reporting for Pension Plans***

This Statement replaces the requirements under GASB Statement No. 25, *Financial Reporting for Defined Benefit Plans and Note Disclosures for Defined Contribution Plans* and Statement No. 50, *Pension Disclosures*. Statement No. 67 applies to pension plan reporting, and is effective for financial statements for fiscal years beginning after June 15, 2013.

#### ***Statement No. 68, Accounting and Financial Reporting for Pensions***

This statement replaces the requirements under GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, and Statement No. 50, *Pension Disclosures*. Statement No. 68 applies to pension reporting for the sponsoring state or local governmental entity, and is effective for fiscal years beginning after June 15, 2014.

The most significant change from the current to the new GASB Statements is the de-linking of pension accounting and funding. Current standards use the annual required contribution (ARC) to set the measurement for funding. The new standards eliminate this reporting requirement. According to the Plain-Language Article released by GASB in June, 2012, "The Board crafted its new Statements with the fundamental belief that funding is squarely a policy decision for elected officials to make as part of the government budget approval process." As a result, the funding policy may be implemented in accordance with the plan design, and requirements established by plan fiduciaries, sponsoring entities, and applicable governing law.

Additionally, under current standards, the sponsor's pension liability is the net pension obligation (NPO), and is measured as the difference between the actual contributions and the ARC. GASB's new standards state that the unfunded portion of a pension liability meets the definition of a liability, and therefore should be reported on the financial statements of the sponsoring entity and the notes to the financial statements of the pension plan. This liability will be reported as the net pension liability (NPL), and will be measured as the total pension liability (TPL) net of the pension plan's assets.

Current standards also require the sponsor to report the annual pension cost (APC), measured as the ARC adjusted for interest on the NPO. The new standards require sponsors to report a pension expense. The pension expense (PE) will represent the change in the NPL from the beginning of the year to the end

of the year, adjusted for the deferred recognition of gains and losses from actuarial assumptions, investment gains and losses, and recognition of actuarial assumption changes.

## **Statement No. 67, Financial Reporting for Pension Plans**

### **Net Pension Liability**

GASB determined that the unfunded portion of a pension liability meets the definition of a liability, and therefore should be reported. This measure of unfunded liability, defined as NPL under GASB standards, will be measured as the TPL net of the pension plan's fiduciary net position<sup>1</sup>. The new standards require that the fair (market) value of assets be used to calculate fiduciary net position, rather than actuarial value of assets, which is currently used in the calculation of NPO.

TPL is the liability for projected benefit payments that is attributed to past employee services. To calculate the TPL, plans will be required to use specific assumptions regarding cost of living adjustments (COLAs), benefit present value calculations, and discount rates. The new standards require the following regarding the calculation of TPL:

- **Ad Hoc COLAs** - Pension liabilities and normal cost currently reflect automatic COLAs; new GASB standards require that pension liabilities and normal cost should also reflect other COLAs now classified as ad hoc COLAs that are substantively automatic.
- **Discount Rate** - The discount rate used to value pension liabilities should be a single rate that is equivalent to using: (1) the long-term expected rate of return on plan investments for payments from the present, for as long as assets are projected to be available to pay benefits, and (2) a high-quality municipal bond index rate for payments after plan assets are projected to be exhausted.
- **Entry Age Actuarial Cost Method** - Pension liabilities and normal cost should be calculated under a single method: the Entry Age Actuarial Cost Method (Level Percentage of Payroll). Under the new standards, the Ultimate Entry Age Normal Cost (UEANC) Method cannot be used for GASB calculations. The UEANC Method is used by several Texas retirement systems. Under this method, the plan's normal cost is based on plan provisions applying to the newest benefit tier.

The use of fair value of assets will cause more variability in the NPL year over year, when compared to the NPO. The NPL is required to be reported on the notes to the pension plan's financial statements.

### **Timing and Frequency of Actuarial Valuations**

GASB states that for financial reporting purposes, an actuarial valuation of the TPL should be performed at least biennially. The TPL should be determined by (a) an actuarial valuation as of the pension plan's most recent fiscal year-end or (b) the use of update procedures to roll forward

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<sup>1</sup> Fiduciary Net Position – equals fair value of the net assets held in trust for by the pension plan for payment of retirement benefits.

amounts from an actuarial valuation to the plan's most recent fiscal year-end as of a date no more than 24 months earlier than the most recent fiscal year-end. If significant changes occur between assumptions assigned at the actuarial valuation date and the current fiscal year-end, GASB encourages professional judgment to be implemented in the roll forward process, and consideration should be given to determine whether a new actuarial valuation is needed.

### ***Investments***

The plan will be required to report the annual money-weighted rate of return on pension plan investments in the notes to its financial statements.

### ***Deferred Retirement Option Program (DROP)***

The plan will be required to report the balance of the amounts held by the pension plan individual DROP accounts.

### ***Required Supplementary Information***

Schedules of required supplementary information should be presented in the notes to the pension plan's financial statements. Statement No. 68 also requires this information to be included in the notes to the sponsoring entity's financial statements. The required supplementary information includes:

- a 10-year schedule of changes in the NPL;
- a 10-year schedule presenting – TPL, the pension plan's fiduciary net position, NPL, the pension plan's fiduciary net position as a percentage of the TPL, covered-employee payroll, and the NPL as a percentage of covered-employee payroll;
- a 10-year schedule presenting for each fiscal year the annual money-weighted rate of return on pension plan investments; and
- if an actuarially determined contribution is calculated for employers or non-employer contributing entities, a 10-year schedule presenting for each year the following:
  - the required contribution; the amount of contributions recognized during the year by the pension plan in relation to the actuarially determined contribution;
  - the difference between the actuarially determined contribution and the amount of contributions by the pension plan;
  - the covered-employee payroll; and
  - the amounts of contributions recognized by the pension plan in relation to the actuarially determined contribution as a percentage of covered-employee payroll.

## **Statement No. 68, Accounting and Financial Reporting for Pensions**

### **Net Pension Liability**

Under GASB standards, the unfunded pension liability will be calculated as NPL. Statement No. 68 requires that the NPL be reported on the financial statements (balance sheet) of the sponsoring entity. This new requirement will likely increase the liabilities recognized for most sponsoring entities.

### **Timing and Frequency of Actuarial Valuations**

For financial reporting purposes, an actuarial valuation of the TPL should be performed at least biennially. The TPL should be determined by (a) an actuarial valuation as of the measurement date or (b) the use of update procedures to roll forward amounts from an actuarial valuation as of a date no more than 30 months and 1 day earlier than the employer's most recent fiscal year-end. If significant changes occur between assumptions assigned at the actuarial valuation date and the current fiscal year-end, GASB encourages professional judgment to be implemented in the roll forward process, and consideration should be given to determine whether a new actuarial valuation is needed.

### **Pension Expense**

The pension expense (PE) represents gains and losses from actual plan experience deviating from actuarial assumptions. The expense is recognized in current and future periods for changes in actuarial assumptions and differences between assumed and actual economic and demographic factors. It includes amortized non-investment gains and losses, assumption changes, and investment gains and losses.

The closed amortization period for non-investment gains and losses and assumption changes is equal to the average expected future service lives of all active and inactive members. Investment gains and losses for a given year will be amortized over a closed five year period.

The Statement also requires that contributions to the pension plan from the employer should not be recognized in pension expense. Additionally, the Statement clarifies that contributions to the pension plan from non-employer contributing entities that are not in a special funding situation should be recognized as revenue (for the pension plan).

The components of pension expense are<sup>2</sup>:

- normal cost (Paragraph 267);
- interest at the discount rate on the plan's TPL (Paragraph 267);
- an offset of expected return on plan assets (Paragraphs 33, 33(b), and 44(b)(9));
- an amortization of non-investment actuarial gain/loss and assumption changes over an average expected future service of all active and inactive members (Paragraph 33(a));
- five year amortization of investment gains and losses (Paragraph 33(b)); and
- immediate recognition of plan amendments affecting current members (Paragraph 279).

### **Special Funding Situations**

Special funding situations are circumstances in which a non-employer contributing entity is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity or entities (In accordance with requirements specified in paragraph 15 of Statement 68). Assuming a special funding situation exists; non-employer contributing entities must recognize their proportionate share of the collective net pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources.

### **Public Analysis**

Actuaries and other commentators have made the following points about the new standards.

- There will be a de-linking of public pension funding and accounting, as the new pension expense will be less feasible a funding target than the current GASB ARC (Annual Required contribution).
- Pension expense will be more volatile than the GASB ARC.
- Rather than reporting the unfunded liability in the notes to the financial statements, the Net Pension Liability (funded status) will be reported on the plan sponsor's financial statements.
- For underfunded plans, the unfunded liability will probably increase as the discount rate will most likely be lower.
- The amortization period for actuarial changes will be shorter under the new Standards.
- Some public pension plan obligations for accrued liabilities may lack the guarantees necessary for them to be considered liabilities.

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<sup>2</sup> Paragraph references pertain to paragraph numbers in Statement 68.

## **Appendix A – Reference Table for Statement No. 67, Financial Reporting for Pension Plans**

<b>Statement of Fiduciary Net Position</b>		
<b>Line Item</b>	<b>Statement Paragraphs</b>	<b>Description</b>
Investments	18	Reported at fair (market) value.
Liabilities	20	Generally consist of benefits due to plan members and accrued investment and administrative expenses.
<b>Notes to Financial Statements</b>		
<b>Line Item</b>	<b>Statement Paragraphs</b>	<b>Description</b>
Plan Description	30(a)(5)	The pension plan should provide a description of automatic postemployment benefit changes, including automatic cost-of-living adjustments (COLAs), and ad hoc post-employment benefit changes, including ad-hoc COLAs.
Return on Pension Investments	30(b)(4)	The annual money-weighted rate of return on pension plan investments.
Deferred Retirement Option Program (DROP)	30(a)(6) 30(f) and 98	30(f) – (1) A description of the DROP terms (2) The balance of the amounts held by the pension plan for the DROP. 98 - Pension plans containing DROP terms should disclose information about the balances held in individual DROP accounts.
Required Supplementary Information	32	10-Year schedules of required supplementary information relating to the NPL, TPL, contributions, and annual money weighted rate of return.
Net Pension Liability	35	Measured as the total pension liability net of the pension plan's fiduciary net position. (i.e., the difference between total (accrued) pension liability and the fair (market) value of plan assets as of fiscal year-end)
Total Pension Liability	36	The portion of the actuarial present value of projected benefit payments that is attributed to past periods of plan member service.
Timing and Frequency of Actuarial Valuations	37	The total pension liability should be determined by (a) an actuarial valuation as of the pension plan's most recent fiscal year-end or (b) the use of update procedures to roll forward to the pension plan's most recent fiscal year-end amounts from an actuarial valuation as of a date no more than 24 months earlier than the pension plan's most recent fiscal year-end.
Discount Rate	40	The discount rate used to calculate the present value of liabilities should be the single rate that reflects (a) the long-term expected rate of return on plan investments as long as the pension plan is projected to have sufficient assets to make projected benefit payments, (b) A yield or index rate for 20-year, tax-exempt, high-quality municipal bonds, to the extent that the conditions in (a) are not met.
Single Actuarial Cost Method	46	Plan to calculate pension liabilities and normal cost under the Entry Age Normal Cost Method (Level Percentage of Payroll).

## **Appendix B – Reference Table for Statement No. 68, Accounting and Financial Reporting for Pensions**

<b>Financial Statements</b>		
<b>Line Item</b>	<b>Statement Paragraphs</b>	<b>Description</b>
Net Pension Liability	20 and 36-48	Measured as the total pension liability net of the pension plan's fiduciary net position. (i.e., the difference between total (accrued) pension liability and the fair (market) value of plan assets as of fiscal year-end). The net pension liability is required to be presented on the sponsoring entity's Statement of Net Assets (balance sheet).
<b>Notes to Financial Statements</b>		
<b>Line Item</b>	<b>Statement Paragraphs</b>	<b>Description</b>
Timing and Frequency of Actuarial Valuations	22	For financial reporting purposes, an actuarial valuation of the TPL should be performed at least biennially. The TPL should be determined by (a) an actuarial valuation as of the measurement date or (b) the use of update procedures to roll forward amounts from an actuarial valuation as of a date no more than 30 months and 1 day earlier than the employer's most recent fiscal year-end.
Projected Benefit Payments	24	Should include the effects of automatic postemployment benefit changes, including automatic cost-of-living adjustments (automatic COLAs). In addition, projected benefit payments should include the effects of (a) ad hoc postemployment benefit changes, including ad hoc COLAs, to the extent that they are considered to be substantively automatic.
Discount Rate	26-31 and 64-69	The discount rate used to calculate the present value of liabilities should be the single rate that reflects (a) the long-term expected rate of return on plan investments as long as the pension plan is projected to have sufficient assets to make projected benefit payments, (b) A yield or index rate for 20-year, tax-exempt, high-quality municipal bonds, to the extent that the conditions in (a) are not met.
Actuarial Present Value	32	The entry age actuarial cost method should be used to attribute the actuarial present value of projected benefit payments of each employee. Each employee's service costs should be level as a percentage of that employee's projected pay.
Pension Expense	33	Changes in the net pension liability, excluding deferred outflows of resources and deferred inflows of resources, should be recognized in pension expense in the current reporting period.
Contributions	40(d) and 44(b)(6)	A description of contribution requirements
Assumptions	41	Significant assumptions and other inputs used to measure the total pension liability.

<b>Notes to Financial Statements (Continued)</b>		
<b>Line Item</b>	<b>Paragraph</b>	<b>Description</b>
The Pension Plan's Fiduciary Net Position	43	Information about the pension plan's basic financial statements, including information about the pension plan's assets, deferred outflows of resources, liabilities, deferred inflows of resources, and fiduciary net position.
Required Supplementary Information	46	10-Year schedules of required supplementary information relating to the NPL, TPL, contributions, and annual money weighted rate of return.
<b>Special Funding Situations – Situations where an entity other than the employer government is legally responsible for contributing to the plan.</b>		
<b>Line Item</b>	<b>Paragraph</b>	<b>Description</b>
Special Funding Situations	15	<p>Circumstances in which a non-employer entity is legally responsible for making contributions directly to a pension plan that is used to provide pensions to the employees of another entity or entities and either of the following conditions exists:</p> <ol style="list-style-type: none"> <li>a. The amount of the contribution by the non-employer entity is not dependent on one or more events or circumstances unrelated to the pensions. (e.g. 1. A circumstance in which the non-employer entity is required by statute to contribute a defined percentage of an employer's covered employee payroll directly to the pension plan. 2. A circumstance in which the non-employer entity is required by the terms of a pension plan to contribute directly to the pension plan a statutorily defined proportion of the employer's required contributions to the pension plan.)</li> <li>b. The non-employer entity is the only entity with a legal obligation to make contributions directly to a pension plan.</li> </ol>
Proportionate Share of the Collective Net Pension Liability	83 and 92	A liability should be recognized for the employer's proportionate share of the collective net pension liability.
Proportionate Share of Pension Expense	85 and 93	Pension expense should be recognized in an amount equal to collective pension expense, determined in conformity with paragraph 33).