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## THE GASB'S PRINCIPLES-DRIVEN PENSION STANDARD

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In June the Governmental Accounting Standards Board (GASB) issued two exposure drafts of new accounting standards for pensions. These proposed standards embody a new paradigm for governmental pension accounting—a dramatic shift from current standards. Before describing the basis for the GASB's new accounting standards, a little organizational background may be helpful.

The Financial Accounting Foundation (FAF) is an independent organization with the endorsement of the Securities and Exchange Commission and has responsibility for the oversight, administration and finances of both the Financial Accounting Standards Board (FASB) and the Governmental Accounting Standards Board (GASB). The FASB is the designated organization for establishing standards for private sector accounting and financial reporting, while the GASB serves the same role for the public sector. Because of the inherent differences between the private and public sector environments, each organization issues its own respective rules for "Generally Accepted Accounting Principles" (GAAP) as applicable to their respective environments. This is the reason we have private sector GAAP and public sector GAAP. For further background on this issue, we recommend the White Paper prepared by the GASB, Why Governmental Accounting and Financial Reporting is–and Should Be–Different.

The GASB has developed a conceptual framework for governmental accounting much like the FASB has for the private sector. The GASB's "Concept Statements" guide it in developing sound and consistent accounting principles as it sets standards for governmental accounting and financial reporting. The standards must be relevant in, and keep pace with, a dynamic government environment that continues to evolve. The GASB has a policy of periodically reexamining existing standards to evaluate their effectiveness and determine whether improvements are warranted.

Sometimes this means minor changes and other times it means a major overhaul as the GASB has determined is the case currently for pension standards. We note that the current GASB Statements No. 27 and 25 setting forth governmental GAAP for employers and plans respectively were issued in November 1994, prior to the GASB's development of their Concept Statements as well as substantial reevaluation of cost measurement issues for private sector plans.

Accordingly, the GASB has embarked on what will turn out to be, when completed next June, a six-and-a-half-year project to revamp governmental GAAP accounting and financial reporting standards for pensions. It chose not to make the changes in a piecemeal fashion, in phases, but rather to undertake the reexamination all in one project from the ground up (measurement, recognition and disclosure) for both single employer plans and multiple employer public sector plans.

In their own terms, the GASB's stated purpose is to improve governmental accounting and financial reporting and to reexamine the effectiveness of existing government accounting standards for the various users and uses of government financial statements; more specifically, to improve the usefulness of information for making decisions regarding employer-governments and contributing nonemployer-governments. This project affects financial statements prepared with an economic resources measurement focus (i.e., full accrual accounting); note that governments also prepare two other types of financial statements unaffected by this pension project–near-term measurement focus (also known as governmental funds accounting) and budgeting.

Following is a brief timeline of the deliberative process for the GASB's review of governmental pension accounting:

- January 2006–The GASB added pensions to its research agenda, culminating in a major research paper on governmental pension accounting.
- April 2008–The GASB officially added pensions to its project agenda.
- March 2009–The GASB issued an Invitation to Comment. This document embodied an expression of the various current schools of thought on pension valuation issues and was part of the GASB's due diligence process to solicit comments from the public community of users, preparers and auditors so that all interested parties had an opportunity to weigh-in at an early stage in the standards development.

June 2010–The GASB issued Preliminary Views, which set forth the GASB's then-current thinking about its views on a new pension standard. This document was the culmination of a fundamental reconsideration of the nature of governmental pensions and the principles that should drive the GASB's direction on the topic.

- July 2011–The GASB issued two exposure drafts and a plain language supplement, with one exposure draft governing the financial statements of employers (and nonemployer contributing entities) and the other governing financial statements of pension plans themselves. Both are proposed to be effective for periods beginning after June 15, 2012 for certain large single employer plans and their employers and June 15, 2013 for all others. They can be found on the Documents for Public Comment page of the GASB's website.

- June 2012–The scheduled date for the adoption of two new standards amending Statements No. 27 and 25.

The GASB has been driven by certain concepts and principles that have led it to the standards outlined in the two exposure drafts. These concepts and principles derive from its Concepts Statements, the economic transactions at play and the nature of the governmental environment. References below to the Summary and paragraph numbers, as well citations of the relevant Concept Statements, are taken from the exposure draft amending Statement No. 27.

*Objectives*. The objectives of financial reporting are accountability, decision-usefulness and interperiod equity. Concepts Statement 1 as invoked in paragraph 124.

*Accounting, not funding*. The GASB chose to establish standards for accounting and financial reporting, and not to establish standards for financing, funding or regulating plans. Quite simply, the GASB does not establish funding standards for governments to follow. As the GASB's own text states very clearly, nothing in the GASB's accounting standards require employers to contribute any given amounts to the plans. In other words, the proposed standards will not require larger pension contributions (or smaller), as has been implied in certain press reports and commentaries. This flows from the fundamental purpose of the GASB – to set accounting and financial reporting standards. Government pension funding polices are set by some combination of the plan's governing body, the employer and the elected officials, not by the GASB. Paragraph 128.

*Long-term nature of governments*. Government longevity leads to accounting standards that avoid employing measurement approaches that seek to answer questions about whether governments will continue to exist, but rather seek to provide insights into their sustainability and their cost of services. Paragraph 126.

*Cost of services*. The determination of the cost of services, or allocation of resources to government programs, lies at the heart of governmental accounting. Providing useful information concerning the cost of services is essential to the objectives of financial reporting, including that of helping financial report users assess the degree to which interperiod equity has been achieved. Concepts Statements 1 and 4 and paragraph 126.

*Nature of the employer's obligation*. In developing the current Statement No. 27, the GASB viewed the employer's liability as one arising from its obligation to fund the plan. The proposed amendments recognize that the employer's ultimate obligation is to the employee; but they also recognize the three-part relationship among the employer, the employee and the plan. Paragraph 122.

*Consistency and comparability*. The current Statement No. 27 accommodates a wide range of practices in determining the liabilities and expense associated with pension plans, any one of six actuarial cost methods may be used to develop the pension expense recognized and the liability disclosed and such methods can be changed from one year to the next. Different amortization methods may be used to determine the pension expense, and the amortization periods may range from one year to thirty. This has impaired the financial statement users' ability to compare different governments or even to compare the same government to itself over time. For the new accounting standard, the GASB decided to require the use of only one designated cost method and amortization approach for allocating the cost of services to years of employment. This is intended to enhance the consistency and comparability of financial statements without creating a false or forced comparability that might result from not reflecting the substantive differences in the underlying transactions and measurements. Summary and Concepts Statement 1. Employee-employer compensation exchange. The employer's ultimate obligation to the employee arises by virtue of the voluntary exchange transaction between the employee and employer. The pension promise is a form of compensation due the employee in exchange for services rendered. Paragraph 122 and 127.

*Long-term nature of employment relationships*. Recognizing the long-term nature of employment relationships is viewed as consistent with the long-term nature of governments and their plans. A simple review of current U.S. public sector retirement systems (their size, longevity and number of current and expected future retirees and beneficiaries) leads to a recognition of the long-term employment relationship between employers and plan members. The GASB was informed in its interpretation of the accounting notion of cost of services by the long-term nature both of employment relationships and of governments and their plans. Specifically, a measurement approach whose allocation method was intended to assign costs as a level percent of pay over the expected future employment exchange between the individual employee and the employer would best represent the GASB's notion of cost of services and interperiod equity.

*Measurement approach*. While the concept of measurement approaches (formerly known as measurement attributes) has been around for many years, the GASB is current working on a Concept Statement on Recognition of Elements of Financial Statements and Measurement Approaches. Concurrent with this Concepts Statement development, the GASB was deliberating the measurement approach for the total pension liability. After researching and understanding the attributes of all the primary actuarial cost methods, the GASB decided that the entry age normal cost method best reflected the cost of services model over time given the long-term nature of the employment relationships and the long-term nature of governments and their plans. Paragraph 204.

*Cost to taxpayers*. Again, the cost of services to taxpayers lies at the heart of government accounting. In selecting a measurement approach, the GASB rejected the market based measures of liability in favor of one that better reflects the expected long-term cost to taxpayers for fulfilling the pension obligation over time (also known as an expected fulfillment value). The investment earnings of the pension fund over time have a direct reducing effect on the cost of services to taxpayers. The GASB chose to reflect this effect of the pension fund by adopting a discount rate based on a reasonable forward-looking long-term expected rate of return of the pension portfolio, at least to the extent that there are long-term investable assets are expected to be available to pay benefits for current plan members. To the extent there are benefits for which such assets are not expected to be so available, the discount rate for those benefits will reflect a long-term high-quality municipal bond index yield on the reporting date. A single equivalent discount rate is then to be used for all liability-related calculations. Paragraph 122.

*Additional transparency*. To create additional transparency the GASB has decided to include a measure of the pension liability on the face of the financial statement. Under the current Statement No. 27 such a measure of liability is found in the Notes and the Required Supplementary Information (RSI) sections of the financial statement, while the basic financial statements present as a liability only the cumulative shortfall (if any) in meeting a funding obligation. Under the exposure draft the liability section of the basic financial statements would present a measure of the full amount of the current net pension liability. This means that a new, much larger and more volatile liability will appear on government employer's financial statements. Summary and paragraph 145 et seq. GASB exposure drafts are sometimes described in terms of setting a fence post in concrete. At the time the exposure draft is issued, the concrete is beginning to set, with some latitude still remaining for adjustments. Occasionally, the GASB has stepped back and re-issued a second exposure draft when they changed course on a major point. But short of that, there may still be some room for changes to certain aspects of the exposure drafts. Comments can be submitted to the GASB (to the Director of Research and Technical Activities – Project 34-E at director@gasb.org. The deadline for comments has been extended to October 14, 2011.

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