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GASB 25 Exposure Draft on Financial Reporting for Public Pension Plans: 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] This Advisory is intended to provide a more detailed analysis of the Statement 25 exposure draft on financial reporting for pension plans. A separate advisory will cover the Statement 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 single employer plans with assets of $1 billion or more in the first fiscal year ending after June 15, **2010**. For example, for a single employer plan with a plan year beginning July 1 and with assets of $1 billion or more on June 30, 2010, the effective date would be the plan year beginning July 1, 2012. For all other plans, the proposed effective date is for periods beginning after June 15, 2013.

Overview

The exposure drafts propose significant changes in the financial reporting for pension plans[3], and even more significant changes in the reporting by employers. The changes may have a significant impact on the administrative costs of the pension plan.

For the pension plan itself, the Financial Statements simply report information about the plan's assets. The Notes to the Financial Statements and the Required Supplementary Information contain more detail about the pension plan, which is the primary focus of this Advisory. This additional detail is now more standardized between plans, requiring the same actuarial cost method for all plans, restricting the use of the expected return on assets as a discount rate to plans with a sufficient funding policy, requiring a projection of liabilities to the plan's year end, and requiring the use of the market value of assets (Plan's Net Position) as of the plan's year end.

Key Components of Plan Reporting

Plan's Net Position

The GASB 25 exposure draft requires the plan's financial statements to contain a Statement of Plan

[1]See 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.

[3]The exposure drafts would set forth the reporting standards with respect to "qualified trusts." A "qualified trust" is not necessarily a tax qualified trust but does have to provide for irrevocable contributions and protection of the plan assets from creditors.

Net Position and a Statement of Changes in Plan Net Position. These two statements are essentially equivalent to the current Statement of Plan Net Assets and the Statement of Changes in Plan Net Assets. That is, the Plan's Net Position is essentially the market value of assets (including normal adjustments for receivables and payables). The primary change appears to be one of terminology to be consistent (and sometimes confused) with the use of "Net Position" in employer financial statements.

Employer(s) Net Pension Liability

GASB concluded that the liability for pension benefits is the result of a compensation exchange between employers and their employees. The pension plan is just a fund used to accumulate and manage assets for the payment of pension benefits. Hence, the liability for the pension benefits belongs to the plan to the extent it has assets, and to the employer to the extent the plan does not have assets. The Employer(s) Net Pension Liability is GASB's measure of the liability that passes through the plan to the employer(s).

The Employer(s) Total Pension Liability (TPL) is essentially defined as the Actuarial Liability calculated using the Entry Age Normal actuarial cost method and the discount rate determined pursuant to GASB 25. GASB specified that the Entry Age Normal Method is to be applied as a level percentage of projected pay on an individual plan member basis. The measurement of the TPL must be within 24 months of the plan's financial statement date and must be projected to the plan's financial statement date. For example, the TPL reported in the plan's financial statements as of June 30, 2014, must be based on the latest actuarial valuation, but not earlier than June 30, 2012, and the TPL calculated in that valuation must be projected to June 30, 2014.

Cheiron Observation: *Most public pension plans already use the Entry Age Normal actuarial cost method, however, many do not use the particular method specified by GASB. A significant change is the projection from the valuation date to the end of the plan's reporting year, and for some plans, the use of a different discount rate. Multiple employer plans would also have to project the TPL to* ***each*** *employer's fiscal year end.*

The Employer(s) Net Pension Liability (NPL) simply equals the TPL minus the Plan's Net Position (Market Value of Assets) as of the plan's reporting date. The NPL is equivalent to the unfunded actuarial liability (UAL) based on the market value of assets (not the smoothed actuarial value currently reported). Consequently, the NPL will be much more volatile than the UAL currently reported.

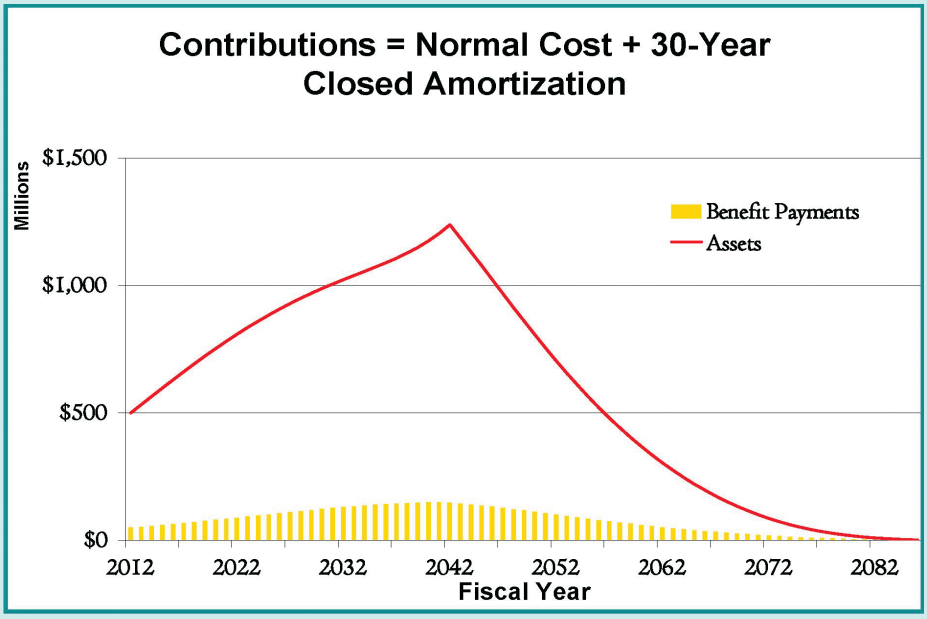
Discount Rate

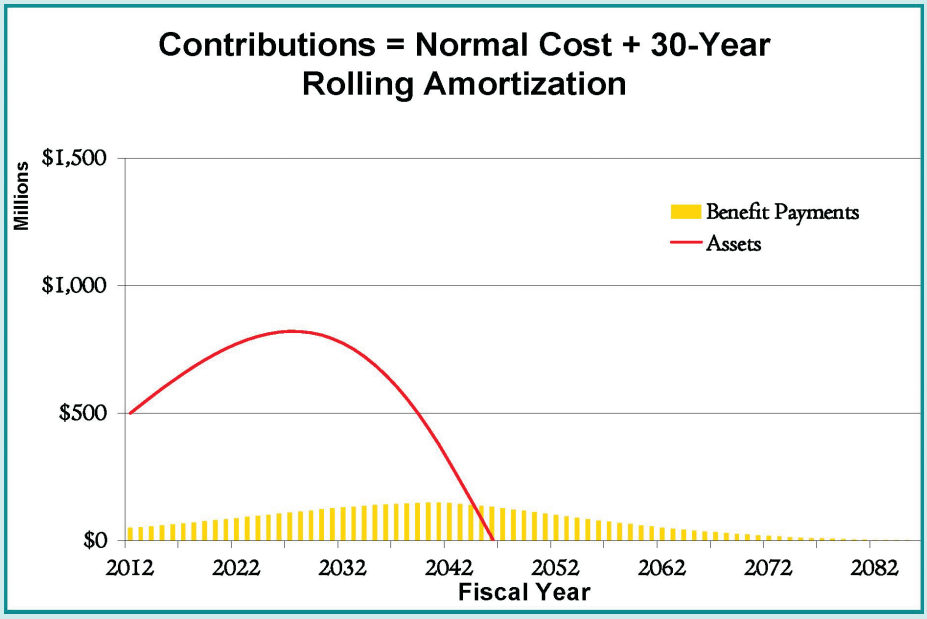
The discount rate used to calculate the TPL should be the long-term expected rate of return on pension plan investments to the extent those investments are projected to be sufficient to make the projected benefit payments of the plan. If pension plan investments are not expected to be sufficient to make the projected benefit payments, the discount rate is the single rate that is equivalent to (a) the long-term expected return to the extent plan investments can pay for the projected benefit payments and (b) an index rate for a 30-year, high quality, tax-exempt municipal bond for the benefit payments after plan investments are expected to run out.

To determine if plan investments are projected to be sufficient, a projection of future benefit payments for **current** members of the retirement plan is developed. Then, the assets of the plan are projected to determine when, if ever, there would be insufficient assets to make those projected benefit payments. In projecting the assets, future contributions based on the current contribution policies and practices are included except for employee contributions of **future** members and employer normal cost contributions for **future** members.

For example, if the contribution policy of your plan is to contribute the normal cost plus a layered 30-year amortization of the UAL, the projection of assets would include all of the UAL contributions plus the employer normal cost contributions and the employee contributions for **current** employees.

The charts on page three show two examples using projected benefit payments for a pension plan that is 50 percent funded. The red line represents the projected assets and the gold bars represent the annual benefit payments. As long as the red line





remains above the gold bars, there are sufficient assets and a blended discount rate is not required.

The first chart shows the projection assuming the plan uses a 30-year closed amortization period. The assets are clearly sufficient. In fact, in this example, the amortization period could be as long as 45 to 50 years without running out of assets.

The second chart shows the projection using a 30-year rolling amortization period. In this example, the projected assets are insufficient beginning in 2047.

Shortening the amortization period to 15 years still results in a depletion of assets in this example. Plans using a rolling amortization period will need to test their situation as they are likely to require a blended discount rate. If the plan is funded well enough or the amortization period is short enough, the projected depletion of the assets may be very far in the future.

Cheiron Observation: *The pension plans that are most likely to be forced to disclose a blended discount rate are those either with a rolling amortization method, a fixed statutory contribution rate that is not adequate or those that*

have a pattern of not contributing an actuarially determined contribution amount. Asset smoothing methods in which the smoothed value is not expected to equal the market value in future years may also result in minor changes to the discount rate.

If a blended discount rate is required, it is determined by finding the single discount rate that produces the same present value of the projected benefit payments as discounting the projected benefit payments before assets are exhausted using the expected rate of return and discounting the projected benefit payments after assets are exhausted using an index rate for a 30-year, high quality, tax-exempt municipal bond. It is possible in an agent multiple employer plan that each employer would have a different discount rate.

In the example below, the expected return on assets is 8.0% and the municipal bond index rate is 4.5%. The plan is projected to deplete its assets during 2046 using GASB's projection methodology. The first column shows the benefit payments covered by plan assets. These payments are discounted at 8.0% to get a present value of approximately $1.05 billion. The second column shows the benefit payments after assets are depleted. These payments are discounted at 4.5% to get a present value of approximately $0.28 billion. The combined present value is $1.33 billion. In the last column, all benefit payments are discounted at 6.84% to get the present value of $1.33 billion. Consequently, the blended discount rate for this plan would be 6.84%.

Year	Benefit Payments Discounted at: 8.00%	4.50%	*6.84%*
2012	$ 50,670,318	-	$ 50,670,318
2013	53,601,391	-	53,601,391
2014	57,043,356	-	57,043,356
2015	60,630,733	-	60,630,733
2016	64,389,976	-	64,389,976
2045	136,581,891	-	136,581,891
2046	65,442,960	$ 66,674,291	132,117,251
2047	-	127,396,974	127,396,974
2048	-	122,413,928	122,413,928
2049	-	117,216,525	117,216,525
2082	-	3,346,715	3,346,715
2083	-	2,636,039	2,636,039
2084	-	2,046,864	2,046,864
2085	-	1,565,864	1,565,864
2086	-	1,179,581	1,179,581
Present Value	$ 1,054,049,557	$ 278,191,808	$ 1,332,241,365

Cheiron Observation: *There has been wide speculation on the impact of GASB's process for determining the discount rate. We suspect that virtually all systems that contribute an actuarially determined contribution rate will be able to use the expected return on assets as their discount rate. Other systems may need to use a blend between the expected return on assets and a long-term municipal bond index rate.*

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 6 years to a proposed 10 years.

Some of the new disclosures include:

- Description of how the long-term expected rate of return on plan investments was determined
- Reconciliation of changes in the employer(s) total pension liability, plan's net position (market value of assets), and the employer(s) net pension liability
- Impacts on the employer's net pension liability of a one percentage point increase and decrease in the discount rate
- Time-weighted and money-weighted investment returns
- Schedule of funding progress
- Actuarially calculated employer contributions compared to actual employer contributions if an actuarially calculated employer contribution is determined

Expected Rate of Return on Plan Investments

The Exposure Drafts require the description of how the long-term expected rate of return on plan investments was determined to include the following:

- The assumed asset allocation of the portfolio,
- The expected ***real rate of return*** for each major asset class, and
- Whether the expected rates of return are presented as arithmetic or geometric means.

Cheiron Observation: *For many of our clients, we have recommended the use of discount rates lower than the expected rate of return in order to create a margin of conservatism in funding the pension plan. With the divorce between accounting and funding, it is not clear that this same margin of conservatism should be used for accounting purposes.*

Sensitivity of Employer(s) Net Pension Liability to Discount Rate

The requirement to show the impact on net pension liability of different discount rates will require the actuary to perform additional work valuing liabilities at the different discount rates. In addition, the NPL is the difference between the TPL and the market value of assets. Changing the discount rate only changes the TPL (not the market value of assets), so plans that are near 100% funded will show the largest percentage change in NPL for changes in the discount rate.

Time-Weighted and Money-Weighted Investment Returns

The exposure draft requires the plan to disclose a 10-year history of both the time-weighted and money-weighted annual investment returns. The time-weighted investment return is the return the pension plan would have earned if there had been no contributions, benefit payments, or administrative expenses. This measure of investment return is usually used to evaluate investment managers. The money-weighted investment returns reflect the impact of transactions into and out of the fund. For the most part, time-weighted and money-weighted returns will be very similar. However, if a large contribution is made just before a run-up in the stock market, the money-weighted return will be higher, and if a large contribution is made just before a sell-off in the market, the money-weighted return will be lower.

With plans that pay more in benefits than they receive in contributions (i.e., experiencing negative cash flow), the money-weighted return will put more weight on performance at the beginning of the year than at the end of the year.

Actuarially Calculated Employer Contributions

The term "Annual Required Contribution" (usually referred to as the "ARC") has been removed from GASB's lexicon. GASB is very reluctant to define anything that may be interpreted as a funding requirement. However, GASB also understands that some accountability over the funding of the pension plan might be a good thing. So, **if** an actuarially calculated employer contribution is determined, a 10-year schedule comparing actual contributions to actuarially calculated employer contributions is required. As a result, there is an incentive not to determine an actuarially calculated contribution unless the actual contribution will equal it. It will be interesting to see if the plans that have struggled the most to make their annual required contributions under current standards choose to simply not determine an actuarially calculated contribution in order to avoid this disclosure.

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.

Cheiron is a full-service actuarial consulting firm assisting Taft-Hartley, public sector and corporate plan sponsors manage their benefit plans proactively to achieve strategic objectives and satisfy the interests of plan participants and beneficiaries. To discuss how Cheiron can help you meet your technical and strategic needs, please contact your Cheiron consultant, or request to speak to one by emailing your request to ***info@cheiron.us****.*

The issues presented in this Advisory do not constitute legal advice. Please consult with your own tax and legal counsel when evaluating their impact on your situation.