PENSION COMMUNICATION RESOURCES

Contents

Two Sets of Pension Measures

Separating Accounting and Funding for Pensions

Implementation of the new accounting standards for public employee pensions marks a definitive separation between the cost of pension benefits from an accounting and financial reporting standpoint and annual contribution requirements.

Key Points

- Previous accounting standards were heavily influenced by prevalent pension funding principles.
- Those funding principles were determined to be no longer compatible with evolving accounting and financial reporting objectives.

Q&As

Q: ***Why are pension funding principles no longer compatible with accounting?***

A: The liability that was reported in financial statements for pension obligations previously was based on shortfalls between a government's contribution targets (the annual required contribution) and the contributions it actually made. However, this measure of an obligation does not fully represent the pension liability. Likewise, annual contribution targets do not always fully represent pension expense for the reporting period.

Moreover, the GASB concluded that it is not within the scope of its activities to set standards that appear to establish a specific method of funding pensions (that being a policy decision for government officials or other responsible authorities to make) or to regulate a government's compliance with its financing policy or requirements.

Q: ***What are the benefits of an accounting-based approach for reporting pension activities?***

A: One of the primary benefits of an accounting-based approach is that it reports (1) a liability for the amount of pension benefits that have yet to be financed as of a specific point in time and (2) the pension expense that was incurred during the reporting period. The use of an accounting-based approach also enhances comparability between governments because all governments use the same measurement methods. A funding-based approach generally cannot produce comparable measures of the pension liability and pension expense because the methods used to determine how much to contribute to a pension plan each year may differ substantially from government to government.

Additional Resources

Governmental Accounting Standards Board, New GASB Pension Statements to Bring about Major Improvements in Financial Reporting

Governmental Accounting Standards Board, GASB Pension Revamp Introduces Major Improvements, *The User's Perspective* (Summer 2012)

Has the ARC Disappeared?

New accounting standards no longer establish parameters for calculation of an annual required contribution (ARC). However, a government that previously reported an ARC generally will report an actuarially determined contribution (ADC) in required supplementary information (RSI).

Key Points

- The focus of financial reporting will now be on the net pension liability and pension expense as these amounts provide additional information that is more consistent with accounting and financial reporting principles.
- Pension accounting is no longer based on the ARC, but it is expected that most plans will continue to present information about contribution measures similar to the ARC in their financial reports.

Q&As

Q: ***What happened to the annual required contribution (ARC)?***

A: Reporting the pension liability and expense based on the ARC has been discontinued for financial reporting purposes, and the new accounting standards do not establish parameters for the calculation of an ARC. The amounts presented about pensions in a government's financial statements come from an accounting-based approach, rather than a funding-based approach. Information about the extent to which a government is keeping up with either an ADC, which is calculated based on the methodology selected by the government rather than GASB-established parameters (as was required for the ARC), or a statutorily or contractually required contribution is provided as RSI in the financial report. If a government previously reported an ARC, there is a strong chance that the government will report an ADC in RSI.

Q: ***Why not continue to require governments to provide information on the ARC?***

A: The GASB determined that the ARC does not always appropriately reflect the pension expense for the reporting period. The ARC-based approach also gave some financial statement users the impression that the measures of the ARC were comparable across governments. However, because there was a range of methods that were acceptable for purposes of calculating an ARC, this was not the case. For these and other reasons, the new pension accounting is not based on the ARC.

The GASB considered but decided not to establish standards that would require information about the ARC for two primary reasons:

- Continuing to report an ARC would have, in some cases, resulted in three sets of information related to pensions in the financial report—the accounting-based information; the ADC-, statutory-, or contractual-based information; and the ARC-based information.
- Information about the government's ADC, if calculated, is more relevant to the accounting liability than information about an ARC because an ADC is developed using methods selected by the government and is a measure that informs the government's funding policy. The ARC might or might not reflect that policy. As previously noted, however, the ADC that a government reports in RSI might essentially be its ARC.

Additional Resources

Governmental Accounting Standards Board, [GASB's New Pension Standards: Setting the Record Straight]
Governmental Accounting Standards Board, [New GASB Pension Statements to Bring about Major Improvements in Financial Reporting]

Two Sets of Numbers

Generally there are two sets of pension numbers—those related to accounting and those related to funding.

Key Points

- Both sets of numbers serve an important role in government finance.
    - The GASB establishes standards for numbers used for accounting purposes.
    - Governments establish the numbers used for funding—the setting aside of assets for future benefit payments—generally with the advice of actuaries.
- The accounting numbers are intended to provide information about a government's financial status as of the end of the fiscal year (including pension liabilities) and the financial results of the current period's activities (including pension expense).
- Funding numbers—when based upon a valuation that uses reasonable assumptions—reflect an amount that is expected to result in adequate amounts set aside to pay pension benefits over time and establishes a measure to assess the funded status of the pension plan.
- Alternatively, funding might be based on statutory requirements. Statutory requirements may or may not be based on actuarial valuations.

Q&As

Q: ***Why are two sets of numbers needed?***

A: The numbers are intended to tell the story of pension-related activities from two different perspectives. The accounting numbers primarily relate to the determination of pension expense for the reporting period and the pension obligation that was incurred as of a point in time. The funding numbers address how governments approach pension plan funding—a government's policy or statute regarding how much money the government will contribute to the pension plan each year.

Q: ***Which set of numbers are more important?***

A: Both sets of numbers play an important role in government finance. Neither the accounting numbers nor the funding numbers should be ignored.

Q: ***What are the accounting numbers intended to convey?***

A: The accounting numbers convey the amount of deferred compensation (pension benefits) that will be paid to employees after retirement. The amounts reported as liabilities represent the benefits that employees have earned and, therefore, that the government has a present obligation to pay in the future. The *total pension liability* represents the government's promise of (deferred) benefits for work already performed. When the total pension liability exceeds the pension plan's net position (formerly referred to as plan net assets) available for paying benefits, there is a *net pension liability*. Governments will now be required to report that amount as a liability in their financial statements.

Reporting the net pension liability alongside other liabilities, such as outstanding bonds, claims and judgments, and long-term leases, is a major step toward getting all significant resources and obligations into the financial statements and more completely depicting a government's financial status.

The accounting numbers also more closely link the reporting of pension expense with the periods during which pension benefits will actually be earned—as employees work for the government.

The accounting numbers are supported by note disclosures and 10-year trend information. Financial statement users will have access to significantly enhanced information about how governments measure their pension liabilities and pension expense. The information required to be disclosed under the new accounting standards will allow users to determine what has caused increases and decreases in the net pension liability during the past year.

The 10-year trend information will help users to understand not just where a government stands now with respect to its pension obligations, but how it got there. That historical perspective is an important aspect of evaluating government finances.

Q: ***What are the funding numbers intended to convey?***

A: When the funding numbers are based on an actuarial valuation, the intent is to determine the amount of annual contributions to the pension plan that are needed to fund future benefit payments. These annual contribution targets also will appear in the financial report as 10-year trend information, which allows the government to demonstrate its degree of compliance with its funding policy or statute. The funding numbers also are intended to provide information to assess the funded status of the pension plan.

Additional Resources

Governmental Accounting Standards Board, GASB Pension Revamp Introduces Major Improvements, *The User's Perspective* (Summer 2012)

Financial Statement Impact of New Standards

Implementing the Pension Accounting Standards Did Not Create the Liability

A government's pension liability is the result of its promise to provide pension benefits to its employees, not the result of implementing accounting standards.

Key Points

- Governments that provide pension benefits to their employees have been doing so for many years.
    - A promise that pension benefit payments will be made to its employees when they retire gives rise to an accounting liability.
- New accounting standards require the pension liability to be reported in the financial statements.
    - The new standards did not create this pension liability; they improved the approach to measuring the liability that is shown in the financial report.

Q&As

Q: ***Where did the pension liability come from?***

A: An accounting liability is an obligation for a government to make a payment (or to give up resources in some manner) in the future. Governments have pension liabilities because they have promised (or are required) to provide pension benefits to their employees in the future when those employees retire. That promise (or requirement) is a part of employee compensation (in addition to a salary and benefits) and constitutes an obligation that will be reported as a liability under the new accounting standards. In most cases, the obligation to provide pension benefits has existed for decades, predating not only the new accounting standards but also the standards they are replacing.

Q: ***What is the relationship between accounting standards for pensions and a government's liability for pensions?***

A: The accounting standards specify how a government should measure the size of its liability for pension benefits and how that liability should be reported in the government's financial statements. The standards do not tell governments what pension benefits to provide, who to provide the benefits to, or how to finance those benefits. The authority to establish, modify, and finance pension benefits is a policy matter decided upon by governments.

Additional Resources

Why Did the Size of the Government's Pension Liability Change?

New accounting standards change how the pension liability is measured, which might result in pension liabilities being significantly larger or smaller than they were under the previous standards.

Key Points

- New accounting standards include changes in the methods that governments may use to measure their liability for pension benefits.
    - Depending on a government's particular circumstances, these changes might result in a measure of the pension liability that is significantly larger or smaller than the liability that it previously reported in the notes to its financial statements.
- The new standards change the allowable methods for measuring the pension liability in order to improve the comparability of pension liability information across governments.
- The new standards *do not* change the amount governments will have to contribute to their pension plans.

Q&As

Q: ***How is measurement of pension liabilities changing?***

A: Whereas governments used to report their unfunded actuarial accrued liability (UAAL) for pensions, they now report a new measure—the *net pension liability* (NPL). Both the UAAL and the NPL represent the portion of a government's obligation for pension benefits that is not covered by assets contributed to and invested by a pension trust fund. The UAAL and the NPL are both calculated by subtracting (1) a measure of the value of those assets in the plan from (2) a measure of the total cost of future pension benefit payments already earned, stated in current dollars. However, the new accounting standards have changed how the value of plan assets and the total cost of pension benefits are measured. As a result, the new pension liability measure (the NPL) might be notably larger or smaller than the old pension liability measure (the UAAL).

Q: ***What are the components of the NPL?***

A: The NPL equals the total pension liability (a measure of the total cost of future pension benefit payments already earned, stated in current dollars) minus the net position of the pension plan (the value of the assets in the pension trust that can be used to make benefit payments).

Q: ***What changes in the accounting standards may increase the size of the pension liability that is reported?***

A: The net pension liability may be greater than the UAAL if the total pension liability is greater than the old measure (the actuarial accrued liability or AAL) of the total cost of future pension benefit payments already earned.

In simple terms, the measurement of the total pension liability involves three steps:

1. Project future pension benefit payments based on the terms of the pension plan
2. Discount those projected future benefit payments to the value today (their present value)
3. Attribute that present value to periods of past service and future service by employees.

The portion of the present value of future benefit payments that is attributed to past service by employees represents the total pension liability.

The following are the changes in how the total pension liability is measured that most likely would increase the size of the net pension liability that a government reports (if they are applicable to the government):

Discounting projected future benefit payments to their present value

- Discounting projected benefit payments to their present value (step 2) is based upon an assumed *discount rate.* All things being equal, a smaller discount rate produces a larger present value (and, thus, a larger liability).
- The discount rate has, in the past, been based on the long-term expected rate of return on the invested assets of the pension plan trust. The rationale for this discount rate is that, unlike other liabilities, a substantial portion of the pension liability is expected to be satisfied by the investment income generated by the assets in the trust, rather than paid off with just the annually raised resources of the government.
- Under the new accounting standards, if the assets in the trust that are associated with the liability for current members of the plan are (a) projected to generate that long-term investment income and (b) to be sufficient to make the projected benefit payments, then the long-term expected rate of return will be used as the discount rate. However, if it is expected that, at a point in the future, these two requirements will no longer be met, then a government would incorporate a municipal bond rate into the discount rate.
- At present (March 2015), the appropriate municipal bond rate is considerably lower than the typical pension plan long-term expected rate of return. If projected benefit payments are discounted using a lower discount rate, the present value will increase and the pension liability will increase as well.

Attribution of present value to past and future periods

- Under the old accounting standards, governments could choose from six methods of attributing the present value of projected benefit payments (step 3). The new standards allow only one method of attribution, referred to as *entry age.*
- The majority of governments already use entry age, meaning that this change normally would not affect the size of their total pension liability. However, for governments previously using a method other than entry age, the switch to the new method will change the portion of the present value that is attributed to past periods of employee service. That means that the total pension liability will increase or decrease.

Q: ***How may other changes in the accounting standards affect the size of the pension liability that is reported?***

A: Changes in how the value of pension assets is measured will affect the size of the reported pension liability. Whether these changes make the NPL larger or smaller compared with the previously reported pension liability (the UAAL) will depend on the particular circumstances of the government in question.

- Under the old accounting standards, to calculate the UAAL, the value of pension plan assets often was measured as a *smoothed* value of assets. In other words, when the value of the plan's investments increase or decrease each year, the full amount of the change is introduced into the value of assets gradually over several years (most often, three to five years), rather than immediately.

- Under the new accounting standards, smoothing of asset values has been eliminated. Instead, the NPL equals the total pension liability minus the value of the assets in the pension plan that can be used for benefit payments as of the same date as of which the total pension liability is measured.
- In the present market environment (March 2015), the fair value of plan assets may be greater than the smoothed value of assets. As a result, all other things equal, the NPL reported by many governments might be smaller than the UAAL that was reported under the previous standards.

Q: ***If the government's pension liability changes, does that mean governments will need to pay more or less for pension benefits?***

A: The new standards establish how governments should account for and report pensions, but do not determine how much governments have to contribute to their pension plan.

Q: ***What happened to the pension-related liability that used to be reported on the face of the financial statements?***

A: Under the previous standards, some governments reported a pension-related liability in the financial statements called a *net pension obligation* (NPO). Unlike the UAAL and the NPL, the NPO was not a measure of the difference between a government's obligation for pension benefits and the value of assets in the pension plan. Rather, the NPO represented the cumulative amount by which a government's contributions to its pension plan fell short of the actuarially determined contribution targets during the period since the government implemented the previous standards. If a government cumulatively contributed *more* than the contribution targets, it would have reported a net pension *asset* under the previous standards.

Additional Resources

Governmental Accounting Standards Board, GASB Pension Revamp Introduces Major Improvements, *The User's Perspective* (Summer 2012)

Governmental Accounting Standards Board, Podcast: Pensions—Measuring Employers' Pension Liabilities: Projection of Benefit Payments

Governmental Accounting Standards Board, Podcast: Pensions—Measuring Employers' Pension Liabilities: Discounting Projected Benefit Payments

Governmental Accounting Standards Board, Podcast: Pensions—Measuring Employers' Pension Liabilities: Attributing Present Value to Periods

Governments in Cost-Sharing Pension Plans Will Report Their Pension Liabilities

A government participating in a cost-sharing multiple-employer pension plan will recognize its proportionate share of the pension liability for the first time under new accounting standards.

Key Points

- Because the contributions of all of the participating governments in cost-sharing pension plans are pooled, the liability for pensions is measured for all governments combined. Until recently, the portion of the liability not covered by assets in the pension plan trust was not divided among the governments for financial reporting purposes. Consequently, these governments did not report a net pension liability in either their audited financial statements or notes, even though they have an obligation to provide pension benefits to their employees.
- The new accounting standards require governments to calculate their proportion of the collective net pension liability for all governments in the plan. A government in a cost-sharing plan is required to report its portion of the net pension liability (the collective net liability multiplied by its proportion) in its financial statements, along with other liabilities such as outstanding bonds.

Q&As

Q: ***What is a cost-sharing multiple-employer pension plan?***

A: In a cost-sharing multiple-employer pension plan, the contributions of multiple governments and their employees are combined. The pension benefits of the retirees of all participating governments are paid out of this common pool of assets.

Q: ***Do governments in cost-sharing pension plans really have a liability for pension benefits?***

A: For accounting purposes, a government's obligation to make contributions going forward to ensure that sufficient resources are available to make pension benefit payments constitutes a liability. There are at least two reasons why it may not have been apparent to some governments that they had a pension obligation that constituted a liability.

- These governments' contributions to their cost-sharing plan are typically determined by a contract with the plan or by statute; some governments might have believed that their obligation for pensions extended no further than their contractual or statutory requirement to make their contribution.
- Whereas many governments voluntarily choose to provide pension benefits through a cost-sharing pension plan, other governments are required to do so. These governments are obligated to provide pension benefits to their employees regardless of whether they chose to participate in the pension plan.

Q: ***What do the new accounting standards require?***

A: Governments that promise pension benefits (or are required to provide benefits) to their employees and are legally obligated for those benefits are required to report a *net pension liability* (NPL) in their financial statements, along with other liabilities such as outstanding bonds. The NPL equals the total pension liability (a measure of the total cost of future pension benefit payments already earned, stated in current dollars) minus the value of the assets in the pension trust that can be used to make benefit payments. However, because the NPL is measured for all governments in the plan combined, participating governments are required to report only their proportionate share of the collective NPL in their own financial statements.

Q: ***How is the proportionate share determined?***

A: A government's proportionate share of the NPL would equal its proportion multiplied by the collective NPL for the plan as a whole. The new accounting standards encourage that the proportion be calculated as follows: (1) a government's projected long-term contributions to the plan divided by (2) the projected long-term contributions to the plan by all governments (and other entities on behalf of those governments). However, the calculation of a government's individual proportion may be based on other factors that are relevant to how contributions to the plan are determined. For instance, a government's percentage might be determined by dividing (a) the government's contributions in the period prior to the date the NPL is measured by (b) contributions of all participating governments and nonemployer entities during that period.

Q: ***Why do governments in cost-sharing plans have to report their pension liabilities?***

A: Taxpayer associations, municipal bond analysts, and others who use audited financial reports need information about government pension obligations to make decisions and to assess government accountability. Most notably, users of government financial reports want to know the size of a government's pension liability and the degree to which the liability is covered by assets set aside in a pension plan trust fund. These financial report users need this information regardless of what type of pension plan a government participates in. The new pension standards require all governments to report their net pension liabilities regardless of the type of pension plan they have.

Additional Resources

Governmental Accounting Standards Board, Governments in Cost-Sharing Multiple-Employer Defined Benefit Pension Plans

Governmental Accounting Standards Board, Podcast: Pensions—Cost-Sharing Employers

Why Does the Size of the Net Pension Liability Change So Much from Year to Year?

New accounting standards require the net pension liability to be measured in a manner that might result in more significant annual changes in the size of the liability than in the past.

Key Points

- The new accounting standards focus on capturing the economic events that have occurred during the period. Consequently, the size of the pension liability might change more significantly from year to year.

Q&As

Q: ***Why will the new accounting standards potentially result in more significant annual changes in the pension liability than have been reported in the past?***

A: Governments are now reporting a *net pension liability* (NPL) in their financial statements, along with other liabilities such as outstanding bonds. The NPL is a measure of the portion of a government's obligation for pension benefits that is not covered by assets contributed to and invested by a pension trust fund. The NPL is calculated by subtracting the value of those assets in the plan from the total pension liability (a measure of the total cost of future pension benefit payments already earned, stated in current dollars). The value of plan assets is determined as of the same date that the total pension liability is measured. In other words, there is no smoothing of asset values, as had been permitted under the old accounting standards. Because these asset values might change significantly from year to year and there is no smoothing, the NPL also might change significantly.

Additional Resources

Governmental Accounting Standards Board, Podcast: Pensions—Recognizing Changes in Net Pension Liability

How Will the New Accounting Standards Change the Way Governments Calculate Pension Expense?

Governments are implementing new accounting standards that require the annual pension expense to be measured differently than in the past.

Key Points

- The prior accounting standards for pensions, which were closely linked with the approach governments typically take to financing pension benefits, spread certain parts of the costs of pensions over many years.
- The new accounting standards are no longer based on how governments finance their pension benefits and, consequently, governments will immediately report expense for many of the events that affect the net pension liability. The effects of other events will be spread over significantly fewer years than in the past.

Q&As

Q: ***How was the annual pension expense measured under the prior accounting standards?***

A: The amount reported as the annual pension expense under the old accounting standards was based on a measure called the *annual required contribution* (ARC). The ARC had two components. One component—normal or service cost—essentially represented the cost of benefits newly earned by a government's employees during the year. The other component was a portion of the government's unfunded pension liability—the amount of its total pension obligation that was not covered by assets set aside in a pension trust fund. The unfunded liability generally could be recognized into expense over a period of up to 30 years.

Q: ***How do the new accounting standards measure annual pension expense?***

A: The new standards base annual pension expense on the amount by which the reported net pension liability (NPL) increased or decreased during the year. The NPL is a measure of the portion of a government's obligation for pension benefits that is not covered by assets contributed to and invested by a pension trust fund. The NPL is calculated by subtracting the value of those assets in the plan from the total pension liability (a measure of the total cost of future pension benefit payments already earned, stated in current dollars). The NPL changes from year to year as a result of factors that cause either the value of plan assets or the total pension liability to increase or decrease. The amount by which those factors cause the NPL to increase or decrease generally is reported as pension expense in the year in which they occur, although certain amounts are accounted for differently.

Q: ***What types of changes in the NPL are reported in pension expense in the period in which they occur?***

A: Most types of increases or decreases in the NPL are recognized in pension expense in the period in which they occur. These include the following:

- Benefits earned each year
- Interest on the total pension liability
- The effect of changes in the benefit terms
- Projected earnings on plan investments

- Changes in plan net position from events other than contributions and investment earnings.

Q: ***What types of changes in the NPL are not reported in pension expense in the period in which they occur? When are those effects reported in expense?***

A: Increases or decreases in the NPL resulting from certain types of events are introduced into annual pension expense over a period of several years. Of these, the following are introduced into annual pension expense over the average remaining years of service of all members of the pension plan (both current and former employees):

- Changes in the assumptions the government uses when measuring its pension liability—For instance, if a government increased its assumption about how long employees live after retirement, the likely result would be an increase in the total pension liability (because retirees are living longer and, therefore, collect pension benefits for a longer period).
- Differences between (1) the assumptions the government made about demographic and economic factors when measuring its pension liability and (2) what those factors actually turned out to be (often called experience gains and losses)—For instance, if actual salary increases turned out to be less than a government assumed when measuring the total pension liability, the effect would be a reduction from what the total pension liability was expected to be.
- The effects of other changes (1) associated with an individual government that provides benefits through a cost-sharing plan or has a special funding situation, or (2) in circumstances in which the primary government and its component units provide pensions through the same single-employer or individual agent plan.

Increases or decreases in the NPL resulting from the following type of event are introduced into annual pension expense over a five-year period (an approximation of a typical market cycle):

- Differences between (1) what a government assumed would be the income from pension plan investments and (2) the actual investment income—For example, if the actual investment income in a particular year was less than expected, the result would be a lower value of plan assets, and a higher NPL, than was expected.

Q: ***For the exceptions above, how are those changes in the NPL introduced into pension expense over multiple years?***

A: The amounts of increases and decreases in the NPL resulting from those types of events are required to be introduced into pension expense in a "systematic and rational manner." This introduction into pension expense happens as follows:

- One part of the amount of the increase or decrease in the NPL is included in pension expense in the first year.
- The remainder of the increase or decrease in the NPL is reported in a government's statement of net position as a deferred outflow of resources (an increase in the NPL) or a deferred inflow of resources (a decrease in the NPL).

In the next year, another portion of the increase or decrease in the NPL is included in pension expense and the deferral is reduced by the same amount. This continues until the entire amount has been included in pension expense (either the last year of the average remaining years of employee service or the fifth year, as applicable).

Q: ***How do a government's contributions to a pension plan affect pension expense?***

A: Contributions made by a government to the pension plan reduce the NPL. However, they do not affect the annual pension expense reported by the government.

Q: ***What is a deferred outflow of resources or a deferred inflow of resources?***

A: Most inflows of resources and outflows of resources—such as the receipt of property tax payments or the payment of salaries to employees—are reported as revenues or expenses in the year in which they happen. However, certain inflows and outflows of resources that occur in a given year are actually related to future years. Thus, they are reported as deferred inflows of resources or deferred outflows of resources in the financial statements until the future year to which they are related, at which time they are reported as revenues and expenses and the deferrals are eliminated.

Additional Resources

Governmental Accounting Standards Board, Podcast: Pensions—Recognizing Changes in Net Pension Liability

Notes and RSI: A Wealth of New Information

Expanded note disclosures and required supplementary information (RSI) will provide a more comprehensive picture of net pension liabilities and pension expenses.

Key Points

- The expanded information required by the new accounting standards will provide more comprehensive reporting of a government's net pension liabilities and expenses and enhance the comparability of pension information.
- Expanded RSI schedules will provide information about changes in the net pension liability (ultimately over a 10-year period) that can be used to analyze trends in the liability.
- Governments that contribute to a pension plan based on an actuarial valuation or based on statutory or contractual requirements will present schedules in RSI that will demonstrate the degree to which those contribution targets have been met over the past 10 years.

Q&As

Q: ***How will the new standards enhance the usefulness of the information presented in the notes to the financial statements?***

A: Under the new standards, all governments—and cost-sharing governments in particular—will provide more comprehensive information about their pension plans in the notes to the financial statements.

Information that will be required of all governments participating in defined benefit pension plans includes:

- Descriptions of the plan and benefits provided, including changes in the benefits
- Significant assumptions employed in the measurement of the net pension liability, including information about how the long-term expected rate of return was developed and other factors that affect the discount rate
- Balances of the net pension liability and deferred outflows of resources and deferred inflows of resources related to pensions
- An analysis of the net pension liability's sensitivity to changes in the discount rate
- Descriptions of changes in the assumptions used when measuring the net pension liability.

Governments in single-employer and agent pension plans also will be required to include information about changes in the two components of the government's net pension liability—the total pension liability and the pension plan's fiduciary net position. This information will explain the degree to which changes are due to, for example, changes in benefits or investment earnings.

Some of this information had been required in the past, but the new standards provide greater specificity with respect to what information should be presented.

Q: ***How will the new standards enhance the usefulness of trend information about the net pension liability?***

A: The new standards expand the number of years of historical information that will be provided about pensions, as well as the types of information that will be presented about the liability. Under the prior standards, information was provided covering only three-to-six years. Under the new standards, governments will include RSI schedules, some of which will be built prospectively until 10 years of historical information is presented. Additional years of information will provide a greater historical context for the reported pension information and facilitate trend analysis.

Governments in single-employer and agent pension plans will be required to present schedules containing information about the net pension liability, including changes in the components of the government's net pension liability (the same information that is required to be presented for only the current year in the notes) and important ratios. These ratios indicate the magnitude of the pension liability and the degree to which the pension plan's fiduciary net position covers the total pension liability.

Governments in cost-sharing plans will be required to include schedules with information about the pension liability that they report and relevant ratios.

All governments will be required to include notes in the schedules that provide information about factors that significantly affect trends in the schedules.

Q: ***Will users of financial reports still be able to obtain information about plan funding?***

A: Yes. Governments that contribute to a pension plan based on an actuarial valuation or based on statutory or contractual requirements will be required to present 10-year schedules that compare the contribution target to the amount actually contributed by the government, as well as other supporting information. Governments also will be required to disclose information about their funding policy in the notes to the financial statements, including the basis for determining contributions and the contribution rate of the employer and other entities.

Q: How will the new standards affect the RSI that governments were required to report in the past?

A: The new standards greatly expand the amount of information that governments will be required to present in RSI. However, the new standards also change the way governments calculate their pension liabilities for financial reporting purposes. As a result, some of the new pension information governments will be required to present in RSI will not be consistent with the information that they had presented in the past. To prevent a government's RSI schedules from containing information that may not be comparable, governments generally would only include information that is calculated in accordance with the new standards. Thus, in the year of implementation, governments generally would not present historical information in RSI schedules about the pension liabilities that they had reported in the years preceding implementation. Instead, governments will develop the new RSI schedules on a prospective basis.

Additional Resources

Governmental Accounting Standards Board, Podcast: Pensions—Note Disclosures and RSI for Employers with Defined Benefit Pension Plans

Pension Funding Provided by Other Governments (Special Funding Situations)

Governments that are legally responsible for financing any portion of the pension obligations for employees of other governments by making contributions directly to a pension plan, and that meet specific criteria set forth in the new accounting standards regarding the government's obligation for making such contributions, will continue to report that responsibility in their financial statements. However, the information that is reported about that responsibility will change because of the new accounting requirements. This circumstance is referred to as a special funding situation.

Key Points

- A nonemployer government in a special funding situation (a government that has a legal responsibility to make contributions for another government's employees) will report information about the portions of net pension liabilities that their contributions support, rather than only the amounts of the contributions that they make.
- A nonemployer government will classify its expense as a result of a special funding situation in the same manner it classifies similar grants to other entities, rather than as a pension expense.
- An employer benefitting from a special funding situation will report its proportionate share of the collective net pension liability, net of the nonemployer contributing entity's proportionate share of the employer's collective net pension liability.
- An employer benefitting from a special funding situation will report the full expense but will also report an offsetting amount of revenue equal to the portion of that expense that is assumed by the nonemployer contributing entity.

Q&As

Q: ***What is a special funding situation?***

A: A special funding situation exists when (1) a nonemployer government is legally responsible for making contributions directly to a pension plan that covers the employees of another government and (2) certain additional criteria are met. For example, a state government might be legally responsible for the annual contributions to a pension plan that covers employees of school districts within the state. The presence of a special funding situation has implications for the financial reporting of both the employer and the nonemployer government. (If contributions are not made directly to the pension plan by the nonemployer entity or the nonemployer entity is not legally responsible for the pension obligation, it is not a special funding situation.)

Q: ***Nonemployer governments generally did not report a liability for special funding situations in the past. Why are they reporting an additional liability and additional costs under the new pension accounting standards?***

A: In the majority of special funding situations under the prior standards, nonemployer governments reported only the amount of the contribution that they made each year. Because of changes in the way in which pension liabilities are measured and reported generally, the information reported by nonemployer governments that are in special funding situations will be different under the new standards. However, the overall approach that is applied to special funding situations in the new standards is the same as the approach under the prior standards. That is, the government that is legally responsible for making contributions directly to the plan applies the requirements of the pension statements, whether it is the employer or another government.

Q: ***What are the financial reporting requirements for special funding situations under the new accounting standards?***

A: The new standards provide accounting guidance for both nonemployer governments and employer governments that benefit from the special funding situation.

The standards require nonemployer governments in a special funding situation to account for their portion of the employer's net pension liability in a manner that is similar to the reporting requirements for cost-sharing employers. A nonemployer government will recognize in its own financial statements its proportionate share of the employer's net pension liability, pension expense, and pension-related deferred inflows and outflows of resources. However, the nonemployer government will classify its proportionate share of the employer's pension expense in the same manner it classifies grant expenses to other entities.

Governments benefiting from a nonemployer entity's involvement will measure and disclose the full amounts of the related net pension liabilities and pension expense in the notes to their financial statements. However, these governments will *recognize* only their proportionate share of pension liability and pension-related deferrals. In other words, the balances are reduced by the proportionate share assumed by the nonemployer entity. They will recognize the full cost of the pension as pension expense, but they will also recognize revenue for the amount of the nonemployer entity's proportionate share of collective pension expense that is associated with the government.

Q: ***Why does the government that benefits from a special funding situation report the full amount of its pension expense rather than an amount reduced by the nonemployer entity's portion?***

A: Even though another entity is paying for some or all of the pension benefits of its employees, the cost of those benefits is nonetheless the *employer's* cost of providing services—it is a part of the cost of compensating its employees. As a result, the employer will report pension expense as if the nonemployer entity did not assume a portion of the liability. The employer also will report revenue equal to the amount of the pension expense that belongs to the nonemployer entity. This approach to reporting the pension expense associated with a special funding situation is the same under the new standards as under the prior standards. As discussed above, the way in which expense is measured is changed by the new standards; therefore, the amounts reported as expense and revenue by an employer government that has a special funding situation similarly will change.

Additional Resources

Governmental Accounting Standards Board, Special Funding Situations

Discounting Under the New Accounting Standards

The new pension accounting standards require that the rate used to discount projected pension payments to determine the pension liability reported by a government be generally based on the long-term expected rate of return, adjusted for circumstances in which a pension plan is not projected to have assets that are intended to finance those benefits. The point at which this occurs has been frequently referred to as the "crossover" point.

Key Points

- The new pension accounting standards continue to base the discount rate on the long-term expected rate of return on pension plan investments. However, they require that the rate be adjusted should the portion of the plan's projected net position that has been accumulated for the benefits of current employees and retirees not be expected to be sufficient to make those benefit payments.
- If projections show that, in the future, the plan's net position will not be sufficient to make benefit payments when they come due, the discount rate reflects (1) the long-term expected rate of return for the periods in which the plan's projected net position equals or exceeds projected those benefit payments and (2) a municipal bond rate for the periods in which those projected benefit payments exceed the plan's projected net position.
- The pension liability will be larger if a lower discount rate is used. Under present economic conditions, a discount rate that reflects a municipal bond rate for any periods will be lower than a discount rate that reflects only the long-term expected rate of return.

Q&As

Q: ***What is a discount rate and how does it relate to pension accounting?***

A: A discount rate is an interest rate used to calculate the present value (the value in today's dollars) of projected future benefit payments.

Q: ***What discount rate was used under prior standards?***

A: Prior standards required governments to use a discount rate based solely on the long-term expected rate of return on the pension plan's investments.

Q: ***How is the discount rate determined based on the new accounting standards?***

A: Under the new standards, a government can continue to use a discount rate that is based on the long-term expected rate of return as long as the pension plan's net position that has been accumulated for the benefits of current employees and retirees is projected to be sufficient to make those projected benefit payments ("funded" projected benefit payments).

However, if at some future point the benefit payments for current employees and retirees are projected to exceed the amount of plan net position, those projected benefit payments ("unfunded" projected benefit payments) are required to be discounted using an index rate for 20-year general obligation municipal bonds rated AA (or its equivalent) or higher.

Q: What is the "single discount rate" that governments disclose in the notes to the financial statements?

The single discount rate is essentially a weighted average of the long-term expected rate of return and a municipal bond index rate. That rate is determined as the rate that, when applied to all projected benefit payments, results in a present value of projected benefit payments equal to the sum of the (1) the present value of the funded projected benefit payments discounted using the long-term expected rate of return and (2) the present value of the unfunded projected benefit payments discounted using the municipal bond rate.

Q: What is included in the pension plan's projected net position?

A: The pension plan's projected net position should include all assets that are expected to be accumulated in the pension plan in the future to pay the benefits of current employees and retirees. The plan's projected net position is increased by projected future contributions to the plan that are intended to finance the benefits of current employees and retirees (that is, excluding the portion of future contributions that finances the benefits of future employees) and projected earnings on the plan's investments. It is reduced by projected future benefit payments and administrative expenses.

Q: ***Will all governments whose pensions are not 100 percent funded be required to discount their projected benefit payments using a municipal bond rate?***

A: No, the funded status of the pensions is not the deciding factor of whether a municipal bond rate should be used. The pension plan's net position is the starting point for making this determination, and a number of variables, such as future contributions into the plan to pay for benefits for current employees and retirees, are considered in the projection of a plan's future net position. As a result, a plan that currently is less than 100 percent funded may in the future be projected to have sufficient resources to satisfy those future benefit payments. Conversely, a plan that is relatively highly funded might be required to use a municipal bond rate in determining the discount rate.

Q: ***What is the effect on the government's net pension liabilities of the discounting approach in the new accounting standards?***

A: In the current economic environment, the municipal bond rate generally is lower than the long-term expected rate of return. Therefore, if the municipal bond rate is incorporated into the discount rate, it generally will result in the government using a lower discount rate than if the long-term expected return on pension plan investments was used exclusively. If a lower discount rate is used, the present value of future benefit payments will be greater. Because the measurement of the total pension liability is based on the present value of future benefit payments, a larger present value means a government will report a larger net pension liability than it would have if only the long-term expected rate of return was used. In the future, this dynamic could reverse if the bond yields rise significantly.

Q: ***What is meant by the "long-term expected rate of return"? Will governments be required to disclose how they determine this rate?***

A: Under the new accounting standards, *long-term* is intended to reflect a period roughly equal to the number of years between an employee's date of hire and the date when the last pension payment for that employee or the employee's beneficiaries is expected to be made. It does not necessarily mean that the pension plan invests in long-term investments, though that is often the case. Governments will be required to disclose information in the notes to the financial statements about how their long-term expected rate of return was developed.

Additional Resources

Governmental Accounting Standards Board, Podcast: Pensions—Measuring Employers' Pension Liabilities: Discounting Projected Benefit Payments

Governmental Accounting Standards Board, GASB's New Pension Standards: Setting the Record Straight

How the Net Pension Liability Affects Net Position

Changes in the way governments report pension liabilities, expenses, and deferrals might have a significant effect on the net position of governments.

Key Points

- The net position of a government is the residual of all other elements presented in a government's statement of financial position.
- The net position of a government indicates whether the government currently has sufficient resources to satisfy its liabilities. It does not provide information about the amount of resources available to the government to satisfy its immediate operational needs.
- In the year of implementation, the new pension accounting standards might significantly reduce the net position of many governments because the full net pension liability and related deferrals will be recognized for the first time.

Q&As

Q: ***What is net position, and how is it measured?***

A: Net position is the residual of all other elements presented in a government's statement of financial position. It is calculated by subtracting a government's (1) liabilities and deferred inflows of resources from its (2) assets and deferred outflows of resources. Net position is reported in three components:

- Net investment in capital assets (the net book value of a government's capital assets minus the outstanding debt issued to purchase, construct, or renovate them)
- Restricted (limited by external parties to being used for a specific purpose)
- Unrestricted (available for any purpose).

The increase or decrease in net position from one year to the next equals the net of all inflows and outflows reported in the financial statements for that period. Unrestricted net position might have a positive or negative balance.

Q: ***How will the recognition of the net pension liability in the year of implementing the new accounting standards affect the net position of a government?***

A: In the first year of implementing the new standards, the net position of many governments is likely to decrease because either (1) they did not report a pension liability of any type in the financial statements or (2) the net pension liability is greater than the net pension obligation that they had reported in the past. In some instances, the net pension liability will be so large that the combined liabilities and deferred inflows of resources exceed the value of the assets and deferred outflows of resources, resulting in a negative unrestricted net position and possibly a negative total net position.

Q: ***What does a negative balance in net position signify?***

A: A negative balance in net position essentially means that the government does not currently have all of the resources needed to satisfy its liabilities. However, it is not necessarily a sign that a government is in dire financial difficulties.

Q: ***In future periods, can a government's net position improve as a result of the changes in the net pension liability?***

A: Yes. For example, the net position of a government might improve due to the effects of an increase in the value of plan investments, which has the effect of reducing the government's net pension liability.

Additional Resources

Governmental Accounting Standards Board, GASB Pension Revamp Introduces Major Improvements, *The User's Perspective* (Summer 2012)

Auditing Issues

Audit Changes

Significant pension plan and related employer audit guidance has been issued to emphasize how their auditors obtain sufficient appropriate evidence to support their opinions on those financial statements.

Key Points

- The American Institute of Certified Public Accountants (AICPA) has issued new auditing guidance related to pension information.
- This guidance addresses auditor responsibilities associated with the auditing of pension-related census data and allocations to employers in cost-sharing plans.
- In addition, significant changes to agent multiple-employer plan audits have been introduced, which also impact the audits of the participating governments.
- The AICPA is issuing a new chapter in the 2015 edition of the AICPA Audit and Accounting Guide, *State and Local Governments*, that will further address audits of governmental plans and participating governments.

Q&As

Q: *How will the new pension auditing guidance affect the following types of pension plans: (1) cost-sharing multiple-employer, (2) agent multiple-employer, and (3) single-employer?*

A(1): Cost-sharing multiple-employer. Certain financial statement amounts and note disclosures associated with a cost-sharing plan are dependent on the completeness and accuracy of census data (information about the persons covered by the plan). Therefore, the new audit literature has guidance specifically associated with auditing census data which focuses on the responsibility of plans, participating governments, and their auditors for the completeness and accuracy of census data.

In addition, the guidance recommends that a cost-sharing plan prepare the following:

- A schedule showing the proportion of the plan as a whole, based on an acceptable contribution-based formula, that each participating government employer and nonemployer entity represents
- Based on those proportions, a schedule showing the allocation (in dollars) to each government employer and nonemployer entity of the cumulative net pension liability, deferred outflows of resources and deferred inflows of resources (by the source of the deferral), and pension expense (distinguishing the employer's proportionate share of the collective expense from amounts specifically related to individual employers).

The auditing guidance states that in order for an employer and its auditor to rely on the information, the schedules need to be audited by the plan auditor.

A(2): Agent multiple-employer Certain financial statement amounts and note disclosures associated with an agent plan also are dependent on the completeness and accuracy of census data. Therefore, the new audit literature has guidance specifically associated with auditing census data. In addition, the guidance addresses the employer's specific interest in the agent plan's fiduciary net position. In both areas, the guidance suggests audit procedures that would need to be performed by the plan auditor before the employer's auditor can rely on the information.

A(3): **Single-employer.** Certain financial statement amounts and note disclosures associated with a single-employer plan also are dependent on the completeness and accuracy of census data. Therefore, the new audit literature has guidance specifically associated with auditing census data.

Additional Resources

AICPA, Governmental Audit Quality Center, GASB Pensions: Issues and Resources

AICPA, Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting (May, 2014)

AICPA, Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting (February, 2014)

AICPA, Single Employer and Cost-Sharing Multiple-Employer Plans: Issues Associated with Testing Census Data in an Audit of Financial Statements (February, 2014)

AICPA, Auditing Interpretations

AICPA, 2015 Edition of the Audit and Accounting Guide, *State and Local Governments* (will include a chapter addressing the new pension standards)

Potential for Modified Audit Opinions

If a government fails to obtain appropriate evidence to support its pension amounts, that government may receive a modified audit opinion because the auditor requires sufficient appropriate audit evidence to support an opinion.

Key Points

- Depending on the auditor's ability to obtain evidence on the information related to pensions that is presented in the financial statements, the auditor might issue a modified opinion.
- If a modified opinion is provided on the government's financial statements, the type of modification will depend on specific facts and circumstances associated with the pension plan and the government.

Q&As

Q: ***Why would a government receive a modified opinion as a result of the new pension information?***

A: A great deal of interaction and coordination between a plan and a government may be necessary for the government's auditor to obtain evidence on the information related to pensions that is presented in the financial statements. The American Institute of Certified Public Accountants (AICPA) provided guidance in the form of white papers and auditing interpretations related to state and local government pension information. This guidance highlights that, in the absence of evidence obtained through the suggested best practices introduced in the AICPA white papers, the auditor of the employer government might not be able to provide an unmodified (clean) opinion on the pension information presented in the employer's financial report.

Q: ***What type of opinion modification would be provided if the auditor of the employer is not able to accumulate sufficient appropriate audit evidence to support the pension amounts and disclosures in the employer's financial statements?***

A: The type of opinion modification will depend on the facts and circumstances associated with the particular government. Depending on the level of evidence provided and quantitative and qualitative materiality considerations, the auditor might issue a qualified or adverse opinion. If little or no evidence is provided, the auditor might disclaim an opinion (that is, not issue an opinion).

Q: ***What can a government do to avoid a modified opinion?***

A: A modified opinion in this instance would likely stem from insufficient audit evidence. Plans, governments, and their auditors need to coordinate and communicate to ensure that governments will be able to corroborate pension amounts in government financial statements.

Additional Resources

AICPA, Governmental Audit Quality Center, GASB Pensions: Issues and Resources
AICPA, Governmental Employer Participation in Agent Multiple-Employer Plans: Issues Related to Information for Employer Reporting (May, 2014)
AICPA, Governmental Employer Participation in Cost-Sharing Multiple-Employer Plans: Issues Related to Information for Employer Reporting (February, 2014)

AICPA, Single Employer and Cost-Sharing Multiple-Employer Plans: Issues Associated with Testing Census Data in an Audit of Financial Statements (February, 2014)

AICPA, Auditing Interpretations

AICPA, 2015 Edition of the Audit and Accounting Guide, *State and Local Governments* (will include a chapter addressing the new pension standards)