
NO. 34 | MARCH 31, 2009

Governmental Accounting Standards Series

INVITATION TO COMMENT

Pension Accounting and Financial Reporting

Comments are requested by July 31, 2009.



Governmental Accounting Standards Board
of the Financial Accounting Foundation

PENSION ACCOUNTING AND FINANCIAL REPORTING

Notice of Public Hearing and Request for Written Comments

Public hearing. A public hearing is scheduled during the Board's regular meeting on August 26, 2009, beginning at 8:30 a.m. in Norwalk, CT. Although interested participants may attend in person, individuals or organizations also may participate in the public hearing by telephone. Details regarding their participation will be provided after the GASB receives a notice of intent to speak.

Deadline for written notice of intent to participate in public hearing: July 31, 2009

Basis for hearing. The GASB has scheduled the public hearing to obtain information from interested individuals and organizations about the issues discussed in this Invitation to Comment. The hearing will be conducted by one or more members of the Board and its staff. Interested parties are encouraged to participate at the hearing and through written response.

Public hearing oral presentation requirements. Individuals or organizations that want to make an oral presentation at the public hearing need to provide, **by the July 31 deadline for notice of intent to participate**, a written notification of that intent and a copy of written comments addressing the issues presented in the Invitation to Comment. The notification and written submission should be addressed to the Director of Research and Technical Activities, Project No. 34, and emailed to director@gasb.org or mailed to the address below. The notification should include a preference for participating in person or via telephone. The public hearing may be canceled if sufficient interest is not expressed by the deadline.

The Board intends to schedule all respondents who want to make oral presentations and will notify each individual or organization of the expected time of the presentation. The time allotted each individual or organization will be limited to about 30 minutes—10 minutes to summarize or elaborate on the written submissions, or to comment on the written submissions or presentations of others, and 20 minutes to respond to questions from those conducting the hearings.

Observers. Observers are welcome at the public hearing and are urged to submit written comments.

WRITTEN COMMENTS

Deadline for submitting written comments: July 31, 2009

Requirements for written comments. Any individual or organization that wants to provide written comments but does not intend to participate in the public hearing should provide those comments **by July 31, 2009**. Written comments may be submitted through an Internet-based form at www.gasb.org/survey/cgi-bin/pafritc.html. Alternatively, comments may be addressed to the Director of Research and Technical Activities, Project No. 34, and emailed to director@gasb.org or mailed to the address below.

OTHER INFORMATION

Public files. Written comments will become part of the Board's public file and will be available for inspection at the Board's offices. Copies of those materials may be obtained for a specified charge.

Orders. Any individual or organization may obtain one copy of this Invitation to Comment on request without charge until July 31, 2009, by writing or phoning the GASB. For information on prices for additional copies and copies requested after that date, please contact the Order Department at the address shown below.

Governmental Accounting Standards Board
401 Merritt 7
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Norwalk, CT 06856-5116

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Pension Accounting and Financial Reporting

March 31, 2009



Governmental Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

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CONTENTS

| | Page Number |
|---|----------------|
| Notice to Recipients | vii |
| Summary | viii |
| Questions for Readers of This Invitation to Comment | x |
| Chapter 1—Introduction | 1 |
| Project Objectives and Scope..... | 1 |
| Project Background..... | 1 |
| Objective and Structure of This Invitation to Comment..... | 2 |
| Objectives of Financial Reporting | 3 |
| Applicability of Issues to OPEB | 5 |
| Chapter 2—Focus of Accounting and Financial Reporting for Pensions..... | 6 |
| Introduction..... | 6 |
| Potential Focuses of Financial Reporting about Pensions | 6 |
| Views Regarding Financial Reporting of These Processes | 8 |
| Chapter 2 Question | 13 |
| Chapter 3—Issues Related to Liability and Expense Recognition | 14 |
| Introduction..... | 14 |
| Background..... | 14 |
| Concepts Related to Liabilities and Flows of Resources..... | 15 |
| Criteria for Recognition in Basic Financial Statements..... | 16 |
| Alternative Approaches to Recognition by Sole and Agent Employers..... | 17 |
| Chapter 3 Questions..... | 27 |
| Chapter 4—Approaches to Measurement..... | 28 |
| Introduction..... | 28 |
| Future Changes Affecting Benefits..... | 28 |
| Financial Reporting Focus on the Employer’s Funding of Pension Benefits..... | 30 |
| Financial Reporting Focus on the Employer’s Incurred Pension Obligation to Employees..... | 30 |
| Discounting Projected Benefits..... | 32 |
| Chapter 4 Questions..... | 37 |
| Chapter 5—Issues Related to the Use of Actuarial Methods | 38 |
| Introduction..... | 38 |
| Actuarial Cost Methods | 39 |
| Amortization of the Unfunded Accrued Benefit Obligation..... | 42 |
| Method of Determining the Actuarial Value of Plan Assets for Accounting and Financial Reporting Purposes | 48 |
| Chapter 5 Questions..... | 50 |

| | Page Number |
|--|----------------|
| Chapter 6—Accounting by Employers in Cost-Sharing Plans | 51 |
| Introduction..... | 51 |
| Distinctive Accounting and Financial Reporting Requirements for Cost-Sharing Employers | 51 |
| Views Regarding the Requirements for Cost-Sharing Employers | 53 |
| Chapter 6 Question | 56 |
| Chapter 7—Issues Specific to Reporting by Plans | 57 |
| Introduction..... | 57 |
| The Employer-Plan Relationship..... | 57 |
| The Current Model..... | 58 |
| Two Views Regarding Recognition of a Liability in Relation to Benefits..... | 59 |
| Views Regarding Presentation of a Statement of Changes in the Unfunded Accrued Benefit Obligation | 60 |
| Chapter 7 Questions..... | 63 |

NOTICE TO RECIPIENTS

The Governmental Accounting Standards Board (GASB) is responsible for developing standards of state and local governmental accounting and financial reporting that (1) result in useful information for users of financial reports and (2) guide and educate the public, including issuers, auditors, and users of those financial reports.

The due process procedures that we follow before issuing our standards are designed to encourage broad public participation in the standards-setting process. As part of that due process, the GASB is issuing this Invitation to Comment to solicit comments on key pension accounting and financial reporting issues. This Invitation to Comment seeks feedback on possible improvements to the existing standards of accounting and financial reporting for pension benefits by state and local governmental employers and by the trustees, administrators, or sponsors of pension plans.

An Invitation to Comment is a staff document designed to seek comments at a relatively early stage of a project before the Board has reached a consensus view. This Invitation to Comment is a step toward an Exposure Draft of a Statement of Governmental Accounting Standards but is *not* an Exposure Draft, nor does it represent a preliminary view of the Board.

We invite your comments on all matters in this Invitation to Comment, especially those addressed in the questions on the following pages. Because the Board has not yet developed a tentative view on these issues, it is important that you comment on any aspects with which you agree, as well as any with which you disagree. To facilitate our analysis of the response to this Invitation to Comment, it would be helpful if you explain the reasons for your views, including alternatives that you believe we should consider.

SUMMARY

This Invitation to Comment is intended to elicit comments at an early stage of the GASB's reexamination of pension accounting and financial reporting standards. It addresses several key issues related to pension accounting and financial reporting that were raised during the research phase of this reexamination. Ultimately, this process is designed to provide the Board with an opportunity to consider whether modifications to current pension standards are required to better meet the financial reporting objectives of accountability and decision usefulness, including enabling users of financial reports to assess the extent to which interperiod equity has been achieved.

Chapter 1 of the Invitation to Comment introduces the background and objectives of this document. Chapters 2–7 each address a key area of accounting and financial reporting for pensions and then pose questions that are intended to elicit public response.

Chapter 2 considers the fundamental issue of what defined benefit pension processes, transactions, or other events should be the focus of financial reporting. At the conclusion of this chapter, you are asked to consider whether pension financial reporting should focus on the process by which an employer incurs an obligation to employees, the process by which an employer finances its projected future cash outflows, or both processes.

Chapter 3 addresses the recognition of employers' pension liabilities and expenses. You are asked to consider which measure meets the conceptual definition of an employer's liability for pensions, and whether an employer should recognize the effects of pension-related transactions or other events immediately upon occurrence or amortize them over future periods for expense recognition.

Chapter 4 examines alternative approaches to the measurement of pension obligations for accounting and financial reporting purposes. You are asked to consider whether or when projected future changes affecting the benefits that are expected to ultimately be paid in retirement should be incorporated into the projection of benefits and what should be the basis for determining the rate for discounting them to their present value for accounting purposes.

Chapter 5 considers the use of actuarial methods in accounting measurement approaches that involve the amortization of pension costs. You are asked to consider questions related to actuarial methods that the GASB could consider if, after due process, the Board were to adopt an accounting measurement approach that includes amortizing the effects of some transactions or other events over future periods for expense recognition.

Chapter 6 examines issues specific to employers' participation in cost-sharing multiple-employer pension plans. You are asked to consider whether the relationship between a cost-sharing employer and the plan in which it participates differs enough from the relationship of a sole or agent employer to its plan to warrant different liability and expense recognition requirements.

Chapter 7 asks you to consider two questions relating to accounting and financial reporting by defined benefit pension plans. The first relates to what a pension plan should report as the plan's liability for pension benefits. The second relates to whether a defined benefit pension plan should present a statement of changes in the unfunded accrued benefit obligation.

For your convenience, a complete listing of the questions posed in the document immediately follows this summary section. You are asked to consider these questions in the context of the chapters in which the related issues are discussed and to formulate comments to the GASB in that context. The relevant questions are presented again at the end of each chapter.

QUESTIONS FOR READERS OF THIS INVITATION TO COMMENT

The following questions are based on the issues discussed in Chapters 2–7 of this document. Please read the entire discussion of issues in each chapter before answering the related questions. Readers need not answer all of the questions in this document and are encouraged to comment on other issues related to pension accounting and financial reporting.

Chapter 2: Focus of Accounting and Financial Reporting for Pensions

1. To best achieve the financial reporting objectives of accountability and decision usefulness, including the assessment of interperiod equity, which of the following *processes related to pensions* do you believe governmental accounting and financial reporting should *provide information about*, and why?
 - a. The process by which an employer incurs an obligation to employees for defined pension benefits earned by them
 - b. The process by which an employer finances its projected future cash outflows for defined pension benefits
 - c. Both processes.

Chapter 3: Issues Related to Liability and Expense Recognition

2. What obligations of a sole or agent employer associated with pensions meet the definition of a liability in Concepts Statement No. 4, *Elements of Financial Statements*, and why?
 - a. A measure of the cumulative difference between (1) amounts expensed, based on annual required contributions of the employer to the pension plan pursuant to a program of funding pension benefits developed within established parameters, and (2) the amounts the employer actually has contributed to the plan
 - b. A measure of the employer's *unfunded accrued benefit obligation* to employees at the financial report date related to the employment agreement governing the exchange of employee services for salaries and benefits
 - c. Other. (Please identify the obligation that you believe best meets the liability definition.)
3. Which of the following expense recognition patterns is more consistent with the concept, in paragraph 27 of Concepts Statement 4, that *applicability to a reporting period or periods* for purposes of *expense recognition* in government-wide, proprietary fund, and fiduciary fund financial statements should be determined based on the notion of interperiod equity, and why?
 - a. Recognition of the effects of transactions and other events that affect the unfunded accrued benefit obligation as they occur each year
 - b. Deferred recognition (deferral and amortization) of some or all components of pension cost other than normal cost over a number of future years determined by an employer or by plan trustees within accounting parameters.

Chapter 4: Approaches to Measurement

4. Should the projection of pension benefits include or exclude the following projected future changes? Why?
 - a. Automatic cost-of-living adjustments (COLAs)
 - b. Projected future ad hoc COLAs, in circumstances in which ad hoc COLAs are substantively a part of the employment agreement, as demonstrated by an employer's pattern of practice
 - c. Projected future salary increases
 - d. Projected future service credits.
5. What should be the basis for determining the discount rate used for discounting projected pension benefits to their present value for accounting purposes? Why?
 - a. The estimated long-term investment yield for the plan
 - b. A risk-free rate (or a yield curve of risk-free rates applied to cash flows of different maturities)
 - c. The employer's borrowing rate
 - d. An average return on high-quality municipal bonds
 - e. Other.

Chapter 5: Issues Related to the Use of Actuarial Methods

6. *If, after due process*, the accounting measurement approach adopted by the Board for pensions were to be one of those discussed in Chapter 4 that includes the amortization of some components of pension cost for purposes of recognition of an employer's pension expense:
 - a. Which *actuarial cost method or methods* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?
 - b. What should be the *maximum amortization period or periods* permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?
 - c. Should *different maximum amortization periods* be set for different types of changes to the unfunded accrued benefit obligation? Why or why not?
 - d. If you answered yes to question 6c, what should be the *maximum amortization period for benefit changes applied retroactively to past periods of service* that were not substantively a part of the employment agreements that established the compensation for services in those periods or were not previously included in the projection of pension benefits? What should be the maximum amortization period for *actuarial gains and losses*? Why?
 - e. Which *amortization method or methods* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?
 - f. What method or methods of determining the *actuarial value of plan assets* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?

Chapter 6: Accounting by Employers in Cost-Sharing Plans

7. Does the relationship between a cost-sharing employer and the cost-sharing multiple-employer plan in which it participates *differ enough in economic substance* from the relationship that a sole or agent employer has with the plan in which it participates to support different requirements with regard to liability and expense recognition? Which of the following views best represents your view, and why?
- The relationship does differ in economic substance, and current measurement, recognition, and disclosure requirements appropriately account for the pension cost and obligation of an employer in a cost-sharing plan.
 - The relationship does differ in economic substance, and current measurement and recognition requirements are appropriate; however, additional disclosures by cost-sharing employers are needed.
 - The relationship does not differ in economic substance; a cost-sharing employer has a long-term pension obligation based on the employment exchange and should measure and recognize its obligation and expense in a manner similar to that for sole and agent employers.

Chapter 7: Issues Specific to Reporting by Plans

8. Which of the following should a pension plan report as its liability in regard to pension benefits, and why?
- A liability for benefits currently due and payable
 - The accrued benefit obligation, however measured.
9. Should a presentation of changes in the unfunded accrued benefit obligation be a required part of general purpose financial reporting? Why or why not?
- If yes, which financial report(s) should contain that presentation: the employer's, the plan's, or both? Why?
 - If yes, should the presentation be a basic financial statement, a note to the basic financial statements, or required supplementary information? Why?

CHAPTER 1—INTRODUCTION

Project Objectives and Scope

1. In April 2008, the Governmental Accounting Standards Board (GASB) initiated a project to reexamine accounting and financial reporting for postemployment benefits¹—that is, forms of compensation for employee services that are deferred until after employment—including pension benefits and other postemployment benefits (OPEB). This project represents the GASB’s first comprehensive review of its pension standards since they were issued in 1994.
2. All major postemployment benefit accounting and financial reporting issues will be considered by the Board as part of this project. These include issues related to what should be recognized in a state and local government environment as elements of financial statements of employers and postemployment benefit plans, when recognition should occur, and how information should be measured, as well as issues related to note disclosures and required supplementary information.
3. It is the intention of the Board to focus initially on pension accounting and financial reporting issues and also, in a later stage of the project, to consider the applicability of tentative decisions that it reaches to OPEB, consistent with the objective of maintaining a common approach and similar standards for all postemployment benefits to the extent appropriate. This objective was one of the guiding principles of the Board’s deliberations over the current OPEB standards.

Project Background

Developments Since the Issuance of Statements 25 and 27

4. As previously noted, the issues discussed in this Invitation to Comment have not been fully reexamined since the issuance of Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, in 1994. The development of the OPEB standards issued in 2004—Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*—was guided in part by a decision to establish a consistent set of standards for both pensions and OPEB based on the overall approach adopted in Statements 25 and 27.
5. The GASB has expanded its conceptual framework for standards setting by issuing two additional Concepts Statements that formally established concepts not in place when the pension

¹The scope of the project does not include *termination benefits*. Although provided after employment, termination benefits are distinct in nature from postemployment benefits, because they are not provided as deferred compensation for employee services but rather as an incentive to or a consequence of the early termination of services. Potential conclusions reached in this project with regard to accounting for postemployment benefits will not directly affect accounting for termination benefits. However, accounting for termination benefits may be indirectly affected in circumstances in which a termination benefit enhances an existing pension or OPEB plan, and the standards require that the termination benefit be accounted for in conformity with pension or OPEB standards.

and OPEB standards were issued. Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements*, defined the methods by which information is communicated in financial reports, including recognition/display in basic financial statements, notes to basic financial statements, and required supplementary information. Concepts Statement No. 4, *Elements of Financial Statements*, defined elements, including liabilities, outflows, and deferred outflows, which are discussed in this Invitation to Comment.

Pension Accounting Research Project

6. This project follows completion of an extensive research project on pension accounting and financial reporting, which gathered information regarding how effective Statements 25 and 27, as amended, have been in improving accountability and providing decision-useful information, including assisting the users of financial reports in assessing the extent to which interperiod equity has been maintained. The research was conducted during 2006 and 2007, in part as a result of the Board's commitment to periodically reexamine the effectiveness of its standards.

7. A primary objective of the research was to determine how state and local governments and pension plans have applied the requirements of Statements 25 and 27 and how financial reporting reflected the transactions and other events affecting pensions from 1996 to 2005. The research included reviews of pension plans' annual financial reports and of literature regarding pension accounting and reporting issues—such as the additions to the GASB's own body of standards and conceptual framework—as well as surveys of pension plans, users of financial reports, and actuaries. The GASB staff also conducted meetings in which questions were posed for discussion among the participants with regard to pension accounting and financial reporting issues. These included:

- a. A meeting of a project advisory committee comprising persons knowledgeable in the field of pensions—including preparers of employer and plan financial statements, auditors, actuaries, and report users such as municipal bond analysts, legislative and oversight staff, and taxpayer groups
- b. Four regional roundtables (in New York City, San Francisco, Chicago, and Austin) with similarly knowledgeable and diverse groups of participants.

8. A research report that encompasses the research efforts and findings was prepared and presented to the Board in April 2008, at which time the current project was added to the GASB's current technical agenda.

Objective and Structure of This Invitation to Comment

9. The focus of this document is on some of the fundamental accounting and financial reporting issues relative to *pensions*, with the objective of seeking input from all individuals and groups having an interest in those matters. The issues on which the Board is focusing attention in this initial stage of the project were identified during the research discussed in paragraphs 6 and 7. The selection of issues in this Invitation to Comment should not be construed to suggest that other pension issues are not also important or will not be considered at a later stage of the project.

10. The remainder of this Invitation to Comment is arranged in six chapters, each of which discusses a key area of accounting and financial reporting for pensions and concludes by posing questions about the issues for public response:

- a. Chapter 2 considers the fundamental issue of what defined benefit pension processes, transactions, or other events should be the focus of financial reporting.
- b. Chapter 3 discusses the recognition of employers' pension liabilities and expenses.
- c. Chapter 4 examines alternative approaches to the measurement of pension obligations for accounting and financial reporting purposes.
- d. Chapter 5 considers the use of actuarial methods in accounting measurement approaches that involve the amortization of pension costs.
- e. Chapter 6 takes up issues specific to employers' participation in cost-sharing multiple-employer pension plans.
- f. Chapter 7 is devoted to issues relating to reporting by pension plans.

Objectives of Financial Reporting

11. In developing standards of financial reporting, the GASB attempts to achieve, to the fullest extent feasible, the objectives of financial reporting identified in Concepts Statement No. 1, *Objectives of Financial Reporting*. These reporting objectives therefore constitute important concepts that the GASB applies when discussing and reaching tentative conclusions about proposed alternative solutions to accounting issues—and ultimately in developing standards of financial reporting. Consequently, these reporting objectives also provide relevant guidelines for consideration by respondents to the pension accounting and financial reporting issues and questions in this Invitation to Comment.

Accountability

12. The primary financial reporting objective, *accountability*, relates to the duty of public officials in a democracy to provide an accounting to the constituents of the government, including but not limited to the citizenry, for the effects of financial transactions and other events on the government's economic condition—including its financial position, fiscal capacity, and service capacity—and the results of its operations. Key considerations with regard to accountability include identifying and analyzing the relevant events to be accounted for and their effects on or relation to elements of financial statements, determining how those events should be measured, and determining when their financial effects should be recognized or reported in the financial statements.

Decision Usefulness

13. General purpose external financial reporting also should meet the financial reporting objective of providing information that is *useful* to the decisions and judgments that report users make. The users of reported financial information about pensions, and the decisions and judgments they make for which reported financial information is relevant, are potentially diverse. Therefore, different information may be relevant and decision-useful for different users or for different types of decisions or judgments.

14. Users of employer financial reports are presumed to include members of the primary user groups identified in Concepts Statement 1—that is, the citizenry (as taxpayers, service recipients, or voters), legislative and oversight bodies, and investors and creditors (along with municipal security underwriters, bond rating agencies, bond insurers, and financial institutions). Statement 25 specifically identifies plan members, their beneficiaries, and their representatives, as well as the trustees or other governing body of the pension plan, as groups that are (or may be, depending on the circumstances) users of plan financial reports.

15. Decisions and judgments related to pensions for which reported financial information is potentially relevant and useful include, for example:

- a. Sizing of pension benefits and total employee compensation packages
- b. Funding of benefits (when and how much the employer and plan members should contribute)
- c. Proposed changes to plan terms that would affect eligibility for benefits or otherwise affect the amount of benefits
- d. Assessment of the funded status and funding progress of the pension plan
- e. Assessment of the overall economic condition of the employer, the employer’s annual operating results, and the cost of government services
- f. Assessment of the potential effects of future cash-flow demands to fund pension benefits on the credit strength of the employer’s bonds or other debt
- g. Allocation of plan assets for investment purposes.

Not all of these or other types of decisions or judgments may be relevant to all users of financial reports.

Interperiod Equity

16. Another objective of financial reporting, related to both accountability and decision usefulness, is to provide information to help users assess whether or not *interperiod equity* has been achieved. In Concepts Statement 1, the GASB concluded that “. . . financial reporting should help users assess whether current-year revenues are sufficient to pay for the services provided that year and whether future taxpayers [or other resource providers] will be required to assume [financial] burdens for services previously provided” (paragraph 61). In Concepts Statement 4, the GASB added a description of interperiod equity as “the state in which current period inflows of resources equal current period costs of services.” If that state is achieved, then “. . . the burden of the cost of [current period] services is borne by present-year taxpayers and revenue providers” rather than “shifted to future-year taxpayers or revenue providers through an increase in the level of borrowing, for example” or paid from net resources accumulated in past periods. The GASB emphasized that for financial reporting purposes, interperiod equity is not “a goal that is expected to be met for any particular period of time,” but is “a relevant metric to assess accountability” (paragraph 27).

Applicability of Issues to OPEB

17. As previously noted, because the GASB concluded that pension and OPEB are conceptually similar, it elected to adopt the same overall approach to accounting and financial reporting for OPEB in Statements 43 and 45 as previously developed for pensions in Statements 25 and 27. While the phased implementation of Statements 43 and 45 still is in progress, Statements 25 and 27 on accounting and financial reporting for pensions have been in use for a number of years, and more data is available about the application of GASB standards to pensions. Accordingly, the GASB's research to date has focused on the effectiveness of standards as applied to pensions, and this Invitation to Comment also is focused on accounting and financial reporting issues as they apply to pensions. The Board recognizes that the issues respondents are asked to comment on in this document also may have implications with regard to accounting and financial reporting for OPEB.

CHAPTER 2: FOCUS OF ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS

Introduction

1. One of the most fundamental questions about accounting and financial reporting for pensions is: What processes or transactions and other events associated with defined-benefit pensions should be measured and reported in general purpose external financial reports? At the conclusion of this chapter, respondents will be asked to comment on whether accounting and financial reporting should provide information to the diverse users of financial reports about one or both of the following:

- a. The process by which an employer *incurs an obligation to employees for defined pension benefits earned* by them, as a function of the exchange between the employer and employees of salaries and benefits for services, the terms of the pension plan, and the performance and receipt of employee services
- b. The process by which an employer *finances its projected future cash outflows for defined pension benefits* stemming from the same underlying factors—generally by means of an actuarially developed program of funding.

2. In answering the questions about the processes just described, please frame the responses in terms of how the resulting financial reporting would meet the objectives of financial reporting identified by the GASB—accountability and decision usefulness, including interperiod equity (discussed in paragraphs 11–16 of Chapter 1).

Potential Focuses of Financial Reporting about Pensions

Employer’s Incurrence of an Obligation to Employees for Benefits Earned

3. For financial reporting purposes, the GASB classifies pension benefits as a subset of *postemployment benefits*. The GASB has concluded that, in substance, postemployment benefits, including pensions, are part of the total compensation package offered by employers for employee services. That is, postemployment benefits are part of an exchange transaction between the employer and employees of salaries and benefits for services.

4. Within the context of accounting and financial reporting, one way of looking at pensions is to take that exchange transaction—sometimes referred to in this document as the “employment exchange”—as the starting point and to consider the effects of that exchange and related transactions and other events on the elements of an employer’s financial statements. Viewed in this way, in each period an employer receives employee services in exchange for agreed-upon salaries and benefits paid in that same period *and* a promise to provide pensions and other benefits after employment. Those salaries and benefits provided during and after employment comprise the total compensation for employee services, and they are part of the total cost of providing governmental services to constituents in each period. As employees earn a portion of the promised postemployment benefits each year by virtue of their services, the employer incurs an obligation to them for those benefits. Some believe that this obligation, reduced by assets set

aside in trust to pay for them, is not essentially different from liabilities related to the procurement of goods and services generally.

5. The employer's obligation, viewed in this way, has two essential characteristics:
 - a. It is promised compensation to employees (active and retired) still to be paid.
 - b. It is a function of the employment exchange, the specific terms of the pension plan (including, for example, terms related to annual service credits and salary levels), and services rendered by employees to date.²

Employer's Funding of Pension Benefits

6. Within the same accounting and financial reporting context, another way of viewing pensions is in terms of the funding of defined pension benefits. State and local governments typically finance the pension benefits they have promised by means of adopting a program of contributions to a *pension plan*—a dedicated trust overseen by a trustee or board of trustees and often administered by a public employee retirement system (PERS) or other entity. The pension plan performs services that are essential to the orderly administration of pension benefits, including, for example:

- a. Providing the employer a legally separate vehicle for accumulating assets to provide for the payment of promised benefits
- b. Investing plan assets, thereby generating a return on investments that contributes significantly to the funding of benefits
- c. Acting as a fiduciary to ensure that assets are prudently administered and dedicated to providing benefits consistent with the terms of the plan
- d. Paying pension benefits to retirees and their beneficiaries when due.

7. The amounts to be contributed, if any, by the employer or employers each period to the plan may be based on applicable laws or contractual requirements or on a program of funding developed by an actuary. Either way, state and local governmental employers and pension plans typically retain the services of an actuary to help develop a financing solution to a funding issue that may be stated as follows:

What amounts of assets would an employer need to contribute to the plan according to a consistent, regular program of annual contributions, so that the assets contributed, if invested pursuant to a particular investment policy and expected to generate a particular long-term rate of return based on the allocation of assets pursuant to that policy, would, on average, be expected to be sufficient to cover the normal cost each year and amortize (accumulate assets to pay for) the total unfunded accrued benefit obligation associated with past service costs over an acceptable number of future years?

²The amount of the obligation also is affected by transactions related to funding and benefit changes and by other events. Types of transactions and events that may occur and affect an employer's unfunded accrued obligation are addressed in Chapter 3.

8. From a funding perspective, the calculated annual contributions may be used either (a) to determine or (b) to serve as a benchmark for assessing the amounts that an employer actually contributes to the plan each year. The particular pattern of allocation of pension costs to past, present, and future periods for purposes of funding depends, to a significant extent, on the combination of actuarial methods used and assumptions made. Choices of methods reflect, in part, the needs and preferences of the employer with regard to, for example, keeping employer contribution requirements and demands on resource providers as level and predictable as possible.

9. Most actuarial methodologies produce a measure of the employer's unfunded benefit obligation related to past services (termed the unfunded actuarial accrued liability [UAAL]) as a part of the process of determining annual required contributions (ARC). The UAAL is created as, and primarily functions as, a *funding target*. It is not intended to be a direct measure of the employer's obligation to plan members for benefits earned; however, as used in financial reports prepared under Statement 25 and Statement 27 requirements, as amended, it functions as a surrogate for that obligation.

10. Both processes—actuarial funding of benefits and incurring benefit obligations to employees—consider all of the same pension cost factors but in ways that result in (a) different measures of an employer's obligation or funding target at a point in time and (b) different attribution of the ultimate total pension costs to financial reporting periods. An accounting approach that builds upon the measurement process used for funding reflects a similar long-term perspective to that taken in funding state and local governmental pension plans and emphasizes long-term trends over short-term variations in factors that affect benefits.

Views Regarding Financial Reporting of These Processes

Employer's Incurrence of an Obligation to Employees for Benefits Earned

11. Some believe that accounting and financial reporting should report the effects of the employment exchange and related transactions and other events on the elements of an employer's financial statements. These include what they believe is the employer's *liability* to employees for unfunded pension benefits that employees have earned by virtue of their services to date and the terms of the plan. Proponents of reporting on the process of incurring the obligation believe that it would:

- a. Focus financial reporting on accountability for the employment exchange in regard to compensation for employee services
- b. Provide more decision-useful information to employers for decisions related to employee compensation
- c. Better reflect an employer's financial position by directly measuring and reporting the employer's pension liability to employees for unfunded pension benefits earned to date
- d. Contribute to better measurement of the cost of services by measuring pension cost based on the employment exchange, the terms of the pension plan, and the receipt of employee services, rather than on periodic contributions to a pension plan pursuant to an employer's method of financing pension benefits

- e. Provide information more helpful to report users, including taxpayers and other revenue providers, in assessing the degree to which interperiod equity has been achieved by reporting the effects of transactions and other events that increase or decrease the amount of benefits that plan members have earned to date as they occur each period
 - f. Facilitate risk measurement and management.
12. Those who believe that financial reporting should focus on the process of the employer's funding of benefits assert that focusing on the incurrence of the obligation:
- a. Would reflect an inappropriate short-term perspective on pensions—referring to the direct measurement of an employer's obligation to employees for benefits earned by them as of the financial report date.
 - b. Would not be useful in circumstances in which the employer, or sponsor, and the plan are going concerns—referring to:
 - (1) The lack of relevance of a strict point-in-time measure of an employer's obligation to employees based on events that have occurred to the financial report date, if the employer is considered to be an ongoing governmental entity with a sufficient revenue base to assure the payment of benefits when due. In that case, the most relevant information pertains to the projected ultimate costs of providing pensions and the allocation of the burden of financing those costs among financial reporting periods.
 - (2) The information needs and preferences of financial report users such as employers (primarily in regard to funding decisions), plan trustees, public-sector financial analysts, plan members, and others who (a) generally indicate that they find financial reporting that focuses on cost allocation, annual required and actual employer contributions to the pension plan, and funding progress in relation to an actuarially determined funding target to be relevant and useful and (b) have become accustomed to using traditional measures as benchmarks.
 - c. Could introduce more of the period-to-period volatility to which point-in-time values of pension assets and liabilities are subject into financial reporting as a result of focusing on remeasurement of the employer's pension obligation at each financial reporting date—including the possibility (depending on measurement and recognition requirements) that negative annual pension cost could be reported in certain circumstances (for example, as a result of actuarial gains or discount rate changes, if applicable).
 - d. Would impose a second way of measuring and reporting the same factors affecting an employer's pension costs and obligations for the purpose of producing measures for financial reporting purposes that is unnecessary because funding methodology already provides an adequate surrogate.
 - e. Would not be consistent with the nature of pensions in the public sector—referring to pension funding and budgeting processes, traditional funding methods, and traditional benchmarks used to assess employer contributions, funded status, and funding progress.
 - f. Would report information that would be potentially confusing or subject to misuse—referring to the risk that report users would misinterpret information representing one aspect of pensions (for example, the incurrence of an obligation) as representing something else (for example, the funding of the obligation) and the concern that reported financial information would be intentionally or unintentionally misconstrued by some in the political arena to the detriment of that defined benefit pension system.

Employer's Funding of Pension Benefits

13. Some believe that accounting should harmonize with actuarial funding methodology, rather than reflecting a perspective different from that of funding or requiring the reporting of pension information prepared in another way, by:

- a. Using the annual employer contributions calculated originally for funding purposes as the basis for accounting expense measurement, provided that the actuarial methods used and the selection of the actuarial assumptions used are within parameters defining what is acceptable for accounting and financial reporting purposes
- b. Using the UAAL, a funding-target measure produced as part of the process of developing and maintaining a funding program, as the measure of an employer's unfunded accrued benefit obligation for accounting and financial reporting purposes, supplemented by disclosures of the funded status and funding progress of the pension plan.

14. Proponents of this view believe that focusing accounting and financial reporting on providing information about the funding of pension benefits:

- a. Provides measures of an employer's pension obligations and expense that are reflective of the enduring nature of state and local governmental sponsors and the generally assumed status of governmental pension plans as going concerns
- b. Reflects a long-term perspective on pensions and focuses on the total projected cost of the benefits to be provided and the allocation of the present value of the total projected cost to periods, rather than on point-in-time measurement of pension liabilities and assets
- c. Results in measures of annual pension cost over time that reflect systematic allocation of the total projected cost of employees' benefits in a way that some believe better reflects (1) the way that employees earn benefits, when viewed over an employee's whole projected career, and (2) the part that pension cost plays in the total cost of providing government services and trends in the cost of government services over time, in comparison to other approaches that might reflect measures of benefits earned or the cost of services that include the effects of short-term variations in pension measurement factors
- d. Supports a single measurement approach for both actuarial funding and accounting and financial reporting purposes by providing measures that can serve, secondarily, as a surrogate for measures more specifically focused on an employer's pension obligation related to past services and annual pension cost, thus avoiding the need for a second approach for accounting and financial reporting purposes
- e. Provides information in a way that it has long been used and, therefore, is familiar and understandable to many users, including employers, plan trustees and administrators, plan members, and analysts in the public sector
- f. Is relevant and decision-useful, particularly in regard to the pension funding decisions that employers make, by virtue of its focus on the annual contributions required to achieve satisfactory funding results
- g. Provides decision-useful benchmarks, including (1) the funded status of the plan measured in terms of the actuarial funding target, (2) the funding progress trend of the plan over time, (3) an employer's actual contributions over time as percentages of the actuarially determined contributions or annual pension cost, and (4) the net pension obligation, a measure reported as a liability by sole and agent employers that represents an employer's

cumulative contribution shortfall versus actuarially determined contributions since implementing current standards.

15. Those who believe that financial reporting should focus on providing information about an employer's incurred obligation to employees for benefits earned to date, and the effects of transactions and other events that affect that obligation, counter that concentrating on the funding process:

- a. Focuses on reporting the financing of an employer's pension obligation to employees without directly measuring or reporting the obligation itself or, at present, requiring reporting of the quantified financial effects of the transactions and other events that create or change the amount of the obligation (for example, benefit increases applied retroactively to past periods of service)
- b. Does not provide relevant, decision-useful information for employers' decisions about pension benefit levels and proposed benefit changes, as a consequence of its "plan-centric" emphasis on annual employer contributions and the funded status of the plan, rather than on the employment exchange and the total compensation, including pensions, agreed upon for services rendered each period
- c. May understate the employer's obligation to employees for earned pension benefits to date and consequently overstate the funded status of the plan (depending on specific measurement and recognition requirements)
- d. Does not provide information useful in assessing whether interperiod equity has been achieved in regard to pensions, as a result of the use of techniques designed to level contribution rates over time and the deferral and amortization over future periods of pension costs attributable to employee services in past periods
- e. Does not provide measures of an employer's accrued benefit obligation and expense independent of funding for accounting and financial reporting purposes, based on the employment exchange, the plan terms, and services received
- f. Tends to obscure actual volatility of the unfunded accrued benefit obligation and the progress being made in funding the plan over time by incorporating actuarial methods that smooth results.

Both Processes

16. One of the possibilities respondents are asked to consider is whether financial reporting should provide information about *both* the process by which an employer incurs an obligation to employees for pension benefits earned by them *and* the process by which an employer finances the benefits by means of an actuarially developed funding program. Views differ in regard to reporting information that reflects more than one aspect of pensions.

17. Some believe that reporting information about both processes would improve financial reporting because:

- a. Information about just one process or the other would be relevant and decision-useful to certain types of users for certain types of decisions and judgments but would not meet the information needs of other users or be relevant or decision-useful for other types of decisions and judgments. (See the discussion of report users and uses in paragraphs 13–15 of Chapter 1.)
- b. Financial reporting about different aspects of pensions would produce two sets of information that would be relevant and useful for different purposes, which could be made understandable to report users through clear disclosure of the differences.
- c. Reporting information about both processes would potentially enhance all users' understanding of pensions by illuminating more than one aspect.

18. Others believe that financial reporting should provide information about pensions from only a single perspective because:

- a. Only one process is decision-relevant to the users of financial reports.
- b. If information were reported from more than one perspective (1) the expanded information potentially would be confusing to report users or (2) some might use the expanded information selectively for agendas inconsistent with the logical use of the information selected, or in ways detrimental to the interests of one or more of the groups having an interest in pensions, for example, employer, plan members, or taxpayers or other revenue providers.
- c. There would be a risk that analysts or media, for example, would not differentiate the focus and objectives of apparently similar measures and would conclude or report that only one measure was "correct."

19. Some believe that, although the funding-target measure produced by most actuarial funding methodologies that are used for financial reporting purposes is not the *same as* the employer's obligation to employees for benefits earned to date measured directly, it could be viewed as a useful *surrogate for* that obligation. If so, they contend that an additional, direct measure of that obligation would not be necessary for financial reporting purposes. Others have calculated that the two measures potentially, and currently, differ to an extent that they believe could be material to report users' decisions and judgments. (Comparisons depend on specific measurement requirements in regard to the two measures.)

Question

1. To best achieve the financial reporting objectives of accountability and decision usefulness, including the assessment of interperiod equity, which of the following *processes related to pensions* do you believe governmental accounting and financial reporting should provide information about, and why?

- a. The process by which an employer incurs an obligation to employees for defined pension benefits earned by them**
- b. The process by which an employer finances its projected future cash outflows for defined pension benefits**
- c. Both processes.**

CHAPTER 3: ISSUES RELATED TO LIABILITY AND EXPENSE RECOGNITION

Introduction

1. This chapter includes a discussion of issues related to the recognition by sole and agent employers of their liabilities associated with pensions. The chapter also includes a discussion of alternatives regarding how pension-related transactions or other events should be attributed to financial reporting periods for expense recognition purposes. Following the discussion of issues, respondents will be asked to respond to questions about:
 - a. Whether the obligation that meets the conceptual definition of a liability of the employer is (1) a measure of the difference between the annual contributions necessary to maintain acceptable progress toward full funding and the contributions actually made, (2) a measure of the employer's unfunded accrued benefit obligation associated with services received from employees to date, or (3) another alternative.
 - b. Whether, in resource flows statements prepared with a flow of economic resources measurement focus on the accrual basis of accounting, the financial effects of pension-related transactions or other events should be recognized (1) in full at the time that the transactions or other events occur or (2) by amortizing the effects of some or all factors other than normal cost over a number of future financial reporting periods.

The issues addressed in this chapter do not include recognition in financial statements prepared using the flow of current financial resources measurement focus and the modified accrual basis of accounting (governmental fund financial statements). These issues will be addressed in a later stage of the project.

Background

2. In earlier projects, the Board discussed but did not reach a conclusion about the question of whether a measure of a sole or agent employer's unfunded accrued benefit obligation is in concept a *liability* of the employer. The term *unfunded accrued benefit obligation* is used in this Invitation to Comment to describe, generically, the unfunded portion of the employer's obligation for pension benefits attributed to past periods of service. The term is not intended to imply any particular way of measuring the obligation and could encompass, for example, measures based either on the incurrence of a liability for benefits earned or on the application of a funding methodology. In the deliberations leading up to the issuance of Statements 25 and 27, the Board considered whether the measure of the unfunded accrued benefit obligation employed in those Statements is a liability of a pension *plan* and concluded that it is not, for reasons discussed in the Basis for Conclusions of Statement 25. However, the Board did not reach a definitive conclusion in that project about whether the unfunded accrued benefit obligation is a liability of the *employer*.

3. In the deliberations leading to Statements 43 and 45, the Board discussed whether an employer has an obligation for promised benefits that accrues as a function of the services rendered by employees in exchange for salaries and benefits and, if so, whether that obligation might meet a potential conceptual definition of a liability. The Board noted in the Basis for

Conclusions of Statement 45 that work on its conceptual framework regarding elements of financial statements was ongoing and acknowledged that it believed the unfunded accrued benefit obligation for OPEB does meet certain characteristics of a liability of a sole or agent employer. However, the Board concluded that Statement 45 should not require employers to recognize the entire unfunded accrued benefit obligation as a liability, citing several factors, including:

- a. The objective of treating OPEB in a manner consistent with the requirements of Statement 27
 - b. The long-term funding-oriented approach being taken
 - c. The emphasis on cost allocation for expense recognition purposes, rather than on the measurement of an employer's liability at financial report dates and changes in the liability
 - d. Concern about volatility related to short-term fluctuations.
4. Subsequent to the issuance of Statements 27 and 45, the Board finalized Concepts Statements 3 and 4 in April 2005 and June 2007, respectively. The completion of those projects provided additional concepts relevant to the issues discussed in this chapter. Those concepts are relevant, for example, to the consideration of whether the employer's unfunded accrued benefit obligation for pensions, however measured, fits the conceptual definition of a liability of the employer and, if so, whether and how the liability and changes in the liability should be recognized in the employer's accrual-basis financial statements.

Concepts Related to Liabilities and Flows of Resources

5. Concepts Statement 4 identifies the seven *elements*, or fundamental components, of financial statements of state and local governmental entities and provides definitions based on the inherent characteristics of each element. Elements relevant to the pension issues discussed in this chapter include liabilities, outflows of resources, and deferred outflows of resources.

Liabilities

6. Concepts Statement 4 defines the element *liabilities* as "present obligations to sacrifice resources that the government has little or no discretion to avoid." In this context, an *obligation* is defined as "a social, legal, or moral requirement, such as a duty, contract, or promise that compels one to follow or avoid a particular course of action." A *liability* is a type of present obligation defined as "a duty or responsibility to sacrifice resources that the government has little or no discretion to avoid." Often the duty or responsibility to sacrifice resources is unavoidable because it derives from legislative requirements imposed by a higher level government or contractual relationships that are legally enforceable, in the sense that a court could compel the government to fulfill its obligation. For exchange transactions, an obligation becomes a liability, and generally is legally enforceable, when the underlying exchange takes place.

7. In other circumstances, Concepts Statement 4 provides that "a liability will be created, not because it is legally enforceable, but because of a government's actions or conduct," in which case "social, moral, or economic consequences leave the government little or no discretion to avoid the sacrifice of resources." *Constructive liabilities*, as these are called, generally arise from exchange transactions. The understanding between the parties to an exchange may be different

from what is legally enforceable; however, once the other party has transferred resources to a government, the government has a liability to fulfill its part of the agreement. Examples provided in the Concepts Statement include a government's obligations to its employees, in some circumstances, to provide deferred compensation in forms including, for example, vacation pay, sick pay, or postemployment benefits, if such compensation is not legally enforceable.

8. The Concepts Statement notes that circumstances in which a government has little or no discretion to avoid the sacrifice of resources include circumstances in which the government (a) does not have the power to decline to sacrifice resources, (b) cannot defer the sacrifice indefinitely, or (c) would be exposed to more than insubstantial penalty or consequences if it failed to sacrifice the resources. In addition, a government's discretion to avoid the sacrifice of resources may be affected by its own actions or conduct and by others' reliance on the government's actions or conduct.

Outflows of Resources and Deferred Outflows of Resources

9. In the broad terminology used in the GASB conceptual framework, expense is an example of the financial statement element *outflow of resources*. Concepts Statement 4 defines an outflow of resources as "a consumption of net assets [defined as assets less liabilities] by the government that is applicable to the reporting period" (paragraph 24). A related element, *deferred outflow of resources*, is defined as "a consumption of net assets by the government that is applicable to a future reporting period" (paragraph 32). These definitions include, as an essential characteristic, the notion of the applicability of a consumption of net assets to a financial reporting period, current or future. The consumption of net assets often occurs in the same financial reporting period to which it is applicable; however, in some cases, net assets may be consumed in one period but be considered applicable to a future period or periods for accounting and financial reporting purposes.

10. For resource flows statements prepared using the flow of economic resources measurement focus and the accrual basis of accounting, the applicability of a consumption of net assets to a current or future financial reporting period is based on the concept of *interperiod equity*, discussed as follows in Concepts Statement 4:

Interperiod equity is the state in which current period inflows of resources equal current period costs of services. For example, the burden of the cost of services is borne by present-year taxpayers and revenue providers. This burden is not shifted to future-year taxpayers or revenue providers through an increase in the level of borrowing, for example, and accumulated net resources are not used to provide current-period services. Interperiod equity is a relevant metric to assess accountability, rather than a goal that is expected to be met for any particular period of time. [paragraph 27]

Criteria for Recognition in Basic Financial Statements

11. Concepts Statement 3 provides a conceptual basis for selecting the appropriate communication methods to present items of financial information in general purpose external financial reports that contain basic financial statements (for example, comprehensive annual

financial reports). The potential communication methods discussed in the Concepts Statement include recognition in basic financial statements, disclosure in notes to basic financial statements, presentation as required supplementary information, and presentation as supplementary information.

12. *Recognition* is defined as “recording or incorporating an item into a financial statement as an asset, liability, revenue, expense, expenditure, or other element of financial statements.” The Concepts Statement states that “items recognized in a financial statement are intended to provide reliable representations of the effects of transactions and other events” (paragraph 33). Further, items that meet the criteria for recognition—those that are (a) elements of financial statements and (b) measurable with sufficient reliability—are appropriately recognized. For such items, note disclosure may be used to provide additional details; however, neither note disclosure nor presentation as required supplementary information or supplementary information is “an adequate substitute for recognition in the financial statements” (paragraph 34).

Alternative Approaches to Recognition by Sole and Agent Employers

13. Paragraphs 14–28 present three alternative approaches to the *recognition* of transactions and other events related to pensions *in basic financial statements* of sole and agent employers. The alternative approaches differ with regard to when and how the financial effects of pension transactions and other events would flow through the accounts and be recognized in basic financial statements prepared using the flow of economic resources measurement focus and the accrual basis of accounting. (As noted in paragraph 1, recognition in financial statements prepared on the modified accrual basis of accounting is outside the scope of issues addressed in this document.) Each approach is a reflection of a potential combination of ways in which issues raised in this chapter related to determination of what pension liability should be reported and how pension costs should be attributed to periods could be resolved. Issues related to *measurement* are discussed in Chapters 4 and 5.

Alternative 1

14. Alternative 1, the approach followed in Statement 27, emphasizes accounting and financial reporting for pension expense, measured based on a sole or agent employer’s annual contributions calculated as part of an actuarial funding program. It features:

- a. Recognition of current-period normal cost plus an amortized portion of past service cost as expense
- b. Recognition of a liability equal to the cumulative difference between amounts recognized as expense and an employer’s actual pension contributions (referred to in Statement 27 and this chapter as the net pension obligation, or NPO)
- c. Note disclosure of a measure of an employer’s unfunded accrued benefit obligation
- d. Deferral and amortization of past service costs.

15. In Alternative 1, the unfunded accrued benefit obligation, which is calculated using methods adapted from actuarial funding methodology, can be thought of as either (a) an actuarial funding target or (b) a surrogate measure of the employer’s incurred obligation to employees for pension benefits earned by services to date in excess of the amount of assets that have been set

aside in trust for payment. In this approach, neither the employer's unfunded accrued benefit obligation nor the transactions and other events that create it or affect its amount are recognized as such in the financial statements. Rather, the obligation and the effects of these transactions and events are *disclosed* in notes to the financial statements. Pension costs attributed by an actuarial cost method to employee services received to date, other than normal cost, are deferred and amortized for expense recognition purposes. The annual expense amounts are such that, if an employer paid those amounts to the pension plan each year, the contributions made would provide enough assets to cover each year's normal cost and amortize the unfunded accrued benefit obligation over a number of future years.

16. The liability that *is* recognized in the employer's financial statements in Alternative 1, the NPO, represents the cumulative difference to date between the amounts measured and recognized as expense and the amounts actually contributed by the employer. The NPO shows how the employer's contributions to date have compared to a program of employer contribution installments that, if consistently followed, would result in full funding of the unfunded accrued benefit obligation (an obligation disclosed in the notes to the financial statements and in required supplementary information) within a stated number of years consistent with accounting parameters.

17. Table 3.1 depicts how illustrative transactions and other events affecting pensions would be recognized in the accounts, and ultimately in the basic financial statements, of a sole or agent employer in Alternative 1.

Table 3.1: Recognition of Pension Transactions and Events—Alternative 1

| Transaction or Other Event | Cash | Pension Liability (NPO) | Pension Expense |
|---|-----------------|---|---|
| a. Pension plan is created with credit for past service | | Increase—as part of amortization of the unfunded accrued benefit obligation* | Increase—as part of amortization of the unfunded accrued benefit obligation* |
| b. Employees perform service in current period and earn an additional portion of pension benefits (normal cost) | | Increase—by immediate recognition | Increase—by immediate recognition |
| c. Interest accrues on unfunded pension liability | | Increase—as part of amortization of the unfunded accrued benefit obligation* | Increase—as part of amortization of the unfunded accrued benefit obligation* |
| d. Actual economic and demographic factors differ from actuarial assumptions, creating actuarial gains or losses | | Increase or decrease—as part of amortization of the unfunded accrued benefit obligation* | Increase or decrease—as part of amortization of the unfunded accrued benefit obligation* |
| e. Plan and employer change an actuarial method or assumption | | Increase or decrease—as part of amortization of the unfunded accrued benefit obligation* | Increase or decrease—as part of amortization of the unfunded accrued benefit obligation* |
| f. Employer enacts an ad hoc, or nonautomatic, cost-of-living adjustment that was not previously included in the projection of pension benefits | | Increase—as part of amortization of the unfunded accrued benefit obligation* | Increase—as part of amortization of the unfunded accrued benefit obligation* |
| g. Employer changes one or more factors (for example, defined-benefit formula factors or eligibility) that change the amounts of projected pension benefits | | Increase or decrease—as part of amortization of the unfunded accrued benefit obligation* | Increase or decrease—as part of amortization of the unfunded accrued benefit obligation* |
| h. Investment of plan assets produces return for the year | | Decrease or increase—as part of amortization of the unfunded accrued benefit obligation* | Decrease or increase—as part of amortization of the unfunded accrued benefit obligation* |
| i. Employer makes contributions to the pension plan | Decrease | Decrease | |

*In this approach, the unfunded accrued benefit obligation is not recognized as a liability but is disclosed in notes to the financial statements. The effects of transactions and other events that create or change the unfunded accrued benefit obligation, other than normal cost, generally are recognized as expense each year on an amortized basis.

18. Those who prefer the accounting and financial reporting approach illustrated in Alternative 1 offer the following views:

- a. An actuarial measure of the unfunded accrued benefit obligation is an actuarial funding target or *actuarial liability*—rather than as a liability in an accounting sense that should be considered for recognition in an employer’s basic financial statements—because the estimation of the obligation requires the use of assumptions about events far into the future.
- b. Even if the unfunded accrued benefit obligation, however measured for accounting and financial reporting purposes, does meet the *conceptual* definition of a liability, it is doubtful whether any estimate of the obligation is or can be sufficiently reliable to qualify for *recognition* in an employer’s basic financial statements, because of the necessity of making assumptions about future events.
- c. Note disclosure of the unfunded accrued benefit obligation, together with the presentation of funding progress trend information as required supplementary information, provides adequate reporting regarding the employer’s obligation related to unfunded past service costs.
- d. Alternative 1 appropriately measures pension expense in a manner that (1) harmonizes with actuarial funding measurements, (2) provides for deferral and amortization of unfunded past service costs, and (3) accommodates techniques useful in leveling expense to the extent possible. That pattern appropriately reflects the contribution of pension expense to the total cost of government services over time and is tantamount to the achievement of interperiod equity with regard to pensions.
- e. The measure that is recognized as a liability, the NPO, serves as a useful performance indicator by reporting the cumulative difference between amounts recognized as expense and actual employer contributions.

19. Those who disagree with the accounting and financial reporting approach illustrated in Alternative 1 offer these views:

- a. The measure that is recognized as a liability in this alternative, the NPO, does not meet the conceptual definition of a liability.
- b. This approach results in incomplete accountability because it does not provide for recognition of a measure of the employer’s unfunded accrued benefit obligation to employees for pension benefits earned to date. The unfunded accrued benefit obligation does meet the conceptual definition of a liability and is measurable with sufficient reliability to warrant recognition.
- c. Accounting and financial reporting should independently reflect the effects of employers’ defined pension commitments on elements of their financial statements as the underlying transactions and other events occur, rather than attempting to harmonize the measurement and recognition of pension expense with the program of annual funding contributions adopted by each employer within accounting parameters.
- d. By not recognizing the effects of transactions and other events that create or affect the liability (unfunded accrued benefit obligation) each period as they occur, Alternative 1 results in incomplete accountability for changes that may significantly increase an employer’s total obligations and the financial burdens on future taxpayers or revenue providers to amortize the increase—for example, benefit changes that are applied retroactively to increase compensation for past periods of service.

- e. Alternative 1 misattributes past service costs to future periods that do not benefit from them by permitting deferred recognition of past service costs—for example, those created by ad hoc cost-of-living adjustments (COLAs) and other retroactively applied benefit increases. Consequently, Alternative 1 is inconsistent with the concept of attributing costs to financial reporting periods on an interperiod-equity basis.

Alternative 2

20. Under Alternative 2, the pension liability that is recognized in the financial statements is a measure of the employer's unfunded accrued benefit obligation.³ By recognizing the unfunded accrued benefit obligation as the employer's pension liability, Alternative 2 results in recognizing in basic financial statements the effects of transactions and other events that create or affect the amount of the unfunded accrued benefit obligation *as they occur*. Under Alternative 2, all changes in the pension liability each year would be recognized as a change in the employer's net assets in economic-resources, accrual-basis resource flows statements. Different types of changes might be separately classified or captioned in the resource flows statements.

21. Table 3.2 depicts how illustrative transactions and other events affecting pensions would be recognized in the accounts, and ultimately in the basic financial statements, of a sole or agent employer under Alternative 2.

³The measure used to report the unfunded accrued benefit obligation could be the UAAL, which is the measure used in Statement 27, or another measure such as the unfunded projected benefit obligation (unfunded PBO) or the unfunded accumulated benefit obligation (unfunded ABO), which are measures of the actuarial present value of benefits attributed to employee service up to the date of the valuation in excess of plan assets. The unfunded PBO includes assumptions regarding future compensation levels, if applicable, whereas the unfunded ABO does not. These measures are discussed further in Chapter 4.

Table 3.2: Recognition of Pension Transactions and Events—Alternative 2

| Transaction or Event | Cash | Pension Liability | Pension Expense |
|---|-----------------|-----------------------------|-----------------------------|
| a. Pension plan is created with credit for past service | | Increase | Increase |
| b. Employees perform service in current period and earn an additional portion of pension benefits | | Increase | Increase |
| c. Interest accrues on unfunded pension liability | | Increase | Increase |
| d. Actual economic and demographic factors differ from actuarial assumptions, creating actuarial gains or losses | | Increase or decrease | Increase or decrease |
| e. Plan and employer change an actuarial method or assumption | | Increase or decrease | Increase or decrease |
| f. Employer enacts an ad hoc, or non-automatic, COLA that was not previously included in the projection of pension benefits | | Increase | Increase |
| g. Employer changes one or more factors (for example, defined-benefit formula factors or eligibility) that change the amounts of projected pension benefits | | Increase or decrease | Increase or decrease |
| h. Investment of plan assets produces return for the year | | Decrease or increase | Decrease or increase |
| i. Employer makes contributions to the pension plan | Decrease | Decrease | |

22. Those who prefer the approach described in Alternative 2 offer these views:

- a. Alternative 2 appropriately reflects the effects of the employment exchange and related transactions and other events on the elements of an employer’s financial statements, including the employer’s pension liability.
- b. The unfunded accrued benefit obligation meets the conceptual definition of a liability and should be recognized in an employer’s financial statements.
- c. By recognizing the effects of pension-related transactions and other events that affect the unfunded accrued benefit obligation as they occur, Alternative 2 provides (1) appropriate accountability for the financial effects of both decisions and actions by government officials and other events related to pensions, (2) more decision-useful information, and (3)

information that better reflects the effects of employers' decisions and actions on interperiod equity.

- d. By disengaging financial reporting from the objectives and measurement considerations of actuarial funding, Alternative 2 improves the ability of financial reporting to meet its objectives and frees funding from constraints previously imposed by financial reporting as a result of the attempt to harmonize the two, yet does not preclude disclosures related to an employer's funding policy, compliance with that policy, or funding progress pursuant to that policy.
23. Those who disagree with the approach described in Alternative 2 offer these views:
- a. Eliminating the NPO as a liability in employer financial statements would result in the loss of a measure that currently provides accountability—and acts as a decision-useful funding performance measure. The NPO indicates the cumulative extent to which an employer's actual pension contributions have met, fallen short of, or exceeded the amounts, derived from the annual required contributions of the employer to fund the plan, that were recognized as expense.
 - b. Note disclosure and required supplementary information, as currently required by Statement No. 50, *Pension Disclosures*, are appropriate for reporting a measure of the unfunded accrued benefit obligation.
 - c. Symmetry should be maintained between accounting and funding measures in order to best meet the needs of users of governmental financial reports. Providing accounting measures of pension information, including expense, that differ from those produced by the funding methodology would be confusing for those users who make decisions about benefit levels and contribution rates or who seek to understand budgetary or funding obligations of a government.
 - d. Considering the potential volatility to which the unfunded accrued benefit obligation and changes in that obligation are subject, Alternative 2 could result in recognition of fluctuations that are not relevant to the long-term horizon of public pension plans. Further, the recognition of fluctuations could produce measures of expense—and thus measures of the total cost of services—that are less useful than measures based on the systematic deferral and amortization of past service costs.

Alternative 3

24. Alternative 3 reflects the view that the unfunded accrued benefit obligation is a liability of a sole or agent employer and should be recognized in an employer's financial statements, and that normal cost should be recognized as expense as employee services are rendered and received. However, this alternative also incorporates the view that some or all components of the total consumption of net assets by pension-related transactions or other events each year, other than normal cost, should be attributed to future periods rather than to the current period for expense recognition purposes. Accordingly, Alternative 3 can be seen as synthesizing certain features of Alternatives 1 and 2. Specifically, it combines:

- a. Recognition of (1) the unfunded accrued benefit obligation as the employer's pension liability and (2) transactions and other events that create or add to or subtract from the liability, consistent with Alternative 2

b. Deferral and amortization of some or all components of the total consumption of net assets, other than normal cost, for expense recognition purposes based on the application of potential accounting standards, consistent with Alternative 1.

25. Under Alternative 3, the effects of transactions and other events that create or change the amount of the employer's unfunded accrued benefit obligation, and thus consume or add to net assets, might, for purposes of illustration, be initially charged or credited to pension expense, as in Alternative 2. However, if an employer made the initial accounting entries in that manner, at year-end the employer also would make an accounting adjustment. Its purpose would be to defer recognition of any components of the total consumption of net assets that were determined to be applicable to future periods for expense recognition purposes, based on the application of accounting standards. It is assumed for purposes of discussion that normal cost would be recognized at the time employee services were received, and that some or all other components would be recognized each year on an amortized basis, within an established amortization period or periods considered to be consistent with the concept of interperiod equity.

26. Table 3.3 depicts how illustrative transactions and other events affecting pensions would be recognized in the accounts, and ultimately in the basic financial statements, of a sole or agent employer under Alternative 3:

Table 3.3: Recognition of Pension Transactions and Events—Alternative 3

| Transaction or Event | Cash | Pension Liability | Pension Expense | Deferred Pension Cost |
|---|-----------------|------------------------------|------------------------------|------------------------------|
| a. Pension plan is created with credit for past service | | Increase* | Increase* | |
| b. Employees perform service in current period and earn an additional portion of pension benefits | | Increase* | Increase* | |
| c. Interest accrues on unfunded pension liability | | Increase* | Increase* | |
| d. Actual economic and demographic factors differ from actuarial assumptions, creating actuarial gains or losses | | Increase or decrease* | Increase or decrease* | |
| e. Plan and employer change an actuarial method or assumption | | Increase or decrease* | Increase or decrease* | |
| f. Employer enacts an ad hoc, or nonautomatic, COLA that was not previously included in the projection of pension benefits | | Increase* | Increase* | |
| g. Employer changes one or more factors (for example, defined-benefit formula factors or eligibility) that change the amounts of projected pension benefits | | Increase or decrease* | Increase or decrease* | |
| h. Investment of plan assets produces return for the year | | Decrease or increase* | Decrease or increase* | |
| i. Employer makes contributions to the pension plan | Decrease | Decrease | | |
| j. Employer makes an accounting adjustment so that expense recognition of the portion of the total consumption of net assets determined to be attributable to future periods based on the application of accounting standards is deferred | | | Decrease or increase* | Increase or decrease* |

*In this approach, the effects of the illustrative transactions or other events (a)–(i) on the employer’s unfunded accrued benefit obligation would be recognized when the transactions or other events occurred. The accounting adjustment (j) would defer recognition of parts of some or all of the transactions or other events (a)–(h), with the exception of (b), normal cost, based on the application of accounting standards.

27. Those who prefer Alternative 3 offer the following views:
- a. The unfunded accrued benefit obligation meets the conceptual definition of a liability and should be recognized as a sole or agent employer's pension liability. Likewise, the effects of transactions and other events impacting that liability or the measurement of its amount should be recognized. Doing so would improve accountability for an employer's transactions related to contributions and benefits as well as provide information about the effects of other events that affect the measurement of an employer's liability for pension benefits. For example, liability recognition would result in clearer reflection of:
 - (1) The immediate consumption of net assets that occurs when an employer increases pension benefits attributable to past employee services, regardless of the period or periods over which the employer chooses to finance the increased benefits
 - (2) The net effect of factors (such as normal cost, benefit changes, method or assumption changes, and actuarial gains and losses) that add to the liability compared with factors (such as contributions and investment earnings) that reduce the liability each year.
 - b. Normal cost should be recognized as expense as employee services are received each year. Some Alternative 3 supporters also believe that the effects of ad hoc COLAs and other benefit increases applied retroactively to past services should be recognized when granted or agreed to. However, the approach taken to expense recognition should allow for amortization of some or all components of the total consumption of net assets other than normal cost, including, at a minimum, the effects of demographic or economic events not directly controllable by the employer that affect the measurement of the liability and pension expense. The amortization of actuarial gains and losses resulting from differences between assumed and actual experience would be appropriate to level the recognition of short-term volatility in demographic and economic factors affecting measurement. Amortizing gains and losses would result in measuring periodic pension expense in a way that would reflect the pension component of the total cost of government services, viewed from a long-term perspective and without the "noise" of short-term fluctuations that would be expected to even out over time. Supporters of Alternative 3 differ in their ideas about what the maximum amortization period for actuarial gains and losses should be. Some supporters of Alternative 3 also favor amortizing the effects of benefit changes, but do not necessarily agree about whether the maximum amortization period for benefit changes should be the same as, or shorter than, the period for actuarial gains and losses. The essential point of agreement is that under Alternative 3, financial reporting standards would permit or require deferral and amortization of some components of the net change in the unfunded accrued benefit obligation within parameters that would be established consistent with application of the concept of interperiod equity.
28. Those who agree with the rationale of Alternative 1 or Alternative 2 can find common ground with the approach described in Alternative 3 in one part or the other, but do not agree with Alternative 3 in its entirety:
- a. Those who favor Alternative 1 agree with deferred recognition of pension costs other than normal cost as expense. However, they disagree with recognition of the unfunded accrued benefit obligation as a liability of the employer.

- b. Those who favor Alternative 2 agree with recognition of the unfunded accrued benefit obligation. However, they believe that deferring the recognition of pension costs associated with service in past periods to future periods, rather than recognizing them as expense upon the occurrence of transactions or other events that create them, is inconsistent with the concept of interperiod equity.

Questions

2. What obligations of a sole or agent employer associated with pensions meet the definition of a liability in Concepts Statement 4, and why?
 - a. A measure of the cumulative difference between (1) amounts expensed, based on annual required contributions of the employer to the pension plan pursuant to a program of funding pension benefits developed within established parameters and (2) the amounts the employer actually has contributed to the plan
 - b. A measure of the employer's *unfunded accrued benefit obligation* to employees at the financial report date related to the employment agreement governing the exchange of employee services for salaries and benefits
 - c. Other. (Please identify the obligation that you believe best meets the liability definition.)
3. Which of the following expense recognition patterns do you believe is more consistent with the concept, in paragraph 27 of Concepts Statement 4, that *applicability to a reporting period or periods* for purposes of *expense recognition* in government-wide, proprietary fund, and fiduciary fund financial statements should be determined based on the notion of interperiod equity, and why?
 - a. Recognition of the effects of transactions and other events that affect the unfunded accrued benefit obligation as they occur each year
 - b. Deferred recognition (deferral and amortization) of some or all components of pension cost other than normal cost over a number of future years determined by an employer or by plan trustees within accounting parameters.

CHAPTER 4—APPROACHES TO MEASUREMENT

Introduction

1. This chapter addresses issues associated with the projection of benefits and the discounting of projected benefits to their present value, related to the *measurement* of a sole or agent employer's unfunded accrued benefit obligation for pensions for accounting and financial reporting purposes. At the conclusion of the discussion of issues, respondents will be asked to respond to questions regarding:

- a. Whether or when *projected future changes*—such as automatic and ad hoc cost-of-living increases, salary increases, and service credits—should be incorporated into the projection of benefits as part of the measurement of the unfunded accrued benefit obligation
- b. Whether the basis for determination of the *discount rate* for discounting the projected benefits to their present value should be the long-term expected rate of return on plan assets, a risk-free rate or set of risk-free rates, a borrowing rate, or some other method.

Issues related to the potential *recognition* of the unfunded accrued benefit obligation, however that might be measured, were discussed in Chapter 3. Here, respondents are asked to focus on certain issues related to how the obligation should be measured, without regard to the communication method—recognition or other—that ultimately might be required after due process.

Future Changes Affecting Benefits

2. The first question asked at the end of this chapter is whether the following types of *future changes* that would affect the ultimate amounts of pension benefits to be paid in future years *should be included currently* in the projection of benefits as part of the measurement of the unfunded accrued benefit obligation for accounting and financial reporting purposes:

- a. COLAs—considering automatic and ad hoc COLAs separately, and considering also a potential distinction between (1) ad hoc COLAs that were substantively a part of the employment agreements that established compensation for employee services in past periods and (2) those that were not a part of those agreements
- b. Assumed future salary increases of plan members
- c. Assumed future service credits for purposes of (1) projecting eligibility for benefits and (2) projecting the amount of benefits that will be paid in retirement.

Cost-of-Living Adjustments

3. COLAs increase the pension benefits paid to retired plan members by amounts that are defined in dollars or determined by the application of defined factors, often applied to an index of inflation.

4. Provision for *automatic COLAs* is explicitly embedded in the terms of the pension plan. As a result, automatic COLAs occur at predetermined intervals for amounts—or based on the application of factors—that are specified in the plan terms. Automatic COLAs may be viewed as

part of employment exchange transactions that already have occurred, because a provision for them was included in the terms of employment agreements at the time the compensation for services for each period was established. That is, employees exchanged their services for an overall compensation package that included pension benefits with the automatic COLA provision included.

5. By contrast, *ad hoc COLAs* typically are discretionary as to when they occur and in what amounts, and require a decision by a relevant authority each time one is given. Views differ on how *ad hoc COLAs* should be treated for accounting purposes:

- a. Some believe that potential future *ad hoc COLAs* should not be included in the current projection of pension benefits for financial reporting purposes because they (1) are discretionary, (2) have not yet been given (that is, should be viewed as future transactions), or (3) may be difficult to project as to timing and amount.
- b. Others would agree only in part that potential future *ad hoc COLAs* should not be included. They believe that there may be circumstances in which it is reasonable to conclude, based on an employer's pattern of practice, that *ad hoc COLAs* are substantively a part of the plan terms (that is, are constructively a part of past employment exchanges). For example, a government may not have automatic *COLAs* but may have demonstrated over time a pattern of granting recurring *ad hoc COLAs* sized to offset, or partially offset, the effects of inflation. Supporters of this view believe that *in such circumstances*, *ad hoc COLAs* should be included in the projection of benefits for accounting purposes. They believe that including *ad hoc COLAs* will avoid understating (1) an employer's pension obligation to employees for benefits earned through services to date, (2) expense, and (3) employer contributions to the pension plan needed to provide for payment of the benefits that ultimately become due.

6. The notion that benefit terms could be substantively part of the employment agreement despite not being formally included in a written plan document was not included by the GASB in Statements 25 and 27. However, the GASB did apply that notion when developing standards of accounting for OPEB, which, as noted in Chapter 1, were considered by the GASB to be conceptually similar to pensions. The *substantive plan* is defined in Statements 43 and 45 as "the terms of an OPEB plan as understood by the employer(s) and plan members." If the substantive plan notion were applied to pensions as well, the written plan document might comprehensively express the substantive plan in most cases. However, basing the projection of benefits on the substantive pension plan would be a potential way of addressing cases in which the written plan document might be considered to be less than complete for financial reporting purposes. This includes, for example, circumstances in which there has been a pattern of serial *ad hoc COLAs*. A substantive-plan standard would include a responsibility to consider whether the benefit terms expressed in the written plan document differ from the terms as communicated to plan members, understood by the employer and plan members to be part of the employment exchange, and actually applied and demonstrated through a pattern of practice.

7. However, even in circumstances in which there has been a clear pattern of serial *ad hoc COLAs*, some believe that it is inappropriate to treat them as though they are automatic. They believe that impounding anticipated *ad hoc COLAs* into the projection of benefits could unintentionally bias future benefit decisions in favor of granting *ad hoc COLAs* on the grounds

that their effects on the pension liability and annual pension cost have already been accounted for, and thus granting them would have little or no additional *apparent* impact on the financial position of the government.

Projected Future Salary Increases and Projected Future Service Credits

8. The terms of defined benefit pension plans commonly base the amount of benefits in part on (a) an employee's salary level at specified times in the final year or last several years of service, or on an employee's average salary for the several years in which the salary was highest, and (b) service credits for each year of an employee's service. When terms such as these apply, the amount of pension benefits that ultimately will be paid often will depend in part on salary levels that have not yet been attained as compensation and on projected service in future periods that has not yet been rendered by employees.

Financial Reporting Focus on the Employer's Funding of Pension Benefits

9. Some believe that financial reporting for pensions should provide information primarily about the process by which an employer finances its projected future cash outflows for defined pension benefits. As discussed in Chapter 2, the focus of that process, in terms of measurement, is on determining the amounts an employer would need to contribute to a pension plan now and on a regular basis in order to accumulate enough assets to fund projected future cash outflows for benefits.

10. In that context, the objective of the measurement, from the standpoints of both funding and accounting and financial reporting, would best be served by including assumed future salary increases and assumed future service credits in the projection of benefits. Including currently the effects of future salary increases and future service credits that ultimately would affect the amount of benefits, and about which reasonable actuarial assumptions can be made, would be conducive to setting the funding target and the calculated annual contributions at a level to provide funding for the ultimate cash flow requirements.

Financial Reporting Focus on the Employer's Incurred Pension Obligation to Employees

11. Others believe that the focus of financial reporting should be on the process by which employees earn pension benefits and that the employer incurs an obligation to them for the benefits earned by virtue of the terms of the plan and the services rendered. Among those who support that focus, there are a couple of approaches to the question of whether to include or exclude future salary increases and future service credits when projecting benefits for accounting and financial reporting purposes.

Unfunded Projected Benefit Obligation

12. Some favor a measure of the employer's obligation for benefits earned (the unfunded projected benefit obligation [PBO]) that:

- a. Includes projected future salary increases, if it is reasonable to conclude that there is an implied contract that such increases will occur
- b. Considers future service in regard to employees' assumed eligibility to receive pension benefits but does not include future service credits in the projection of future cash outflows for benefits.

13. Proponents of this measurement approach believe that if it is reasonable to conclude that there is an implied contract that future salary increases will occur, then it is appropriate to include future increases in the calculation of the obligation. Some proponents also like that this approach levels the effect of projected salary increases with regard to the calculation of earned benefits for individual employees by anticipating the back-end loading inherent in final-pay or final-average-pay benefit provisions and allocating it over multiple periods. Others, however, argue that the unfunded PBO includes the effects of transactions—future salary increases—that (a) have not yet occurred, (b) should be viewed from the current vantage point as discretionary, and (c) are not relevant to measuring benefits earned to date or the employer's obligation for benefits earned to date.

Unfunded Accumulated Benefit Obligation

14. Others favor a measure of the employer's obligation for benefits earned (the unfunded accumulated benefit obligation [ABO]) that:

- a. Does not include projected future salary increases
- b. Considers future service in regard to employees' assumed eligibility to receive pension benefits but does not include future service credits in the projection of future cash outflows for benefits.

15. Proponents of the unfunded ABO believe that the measurement of the obligation should reflect only transactions and other events that have occurred to date, because it is those transactions and events that determine the benefits earned to date and the employer's present obligation to employees for the benefits earned.

16. Some characterize the unfunded ABO as a termination-oriented approach to measuring an employer's obligation to employees for benefits earned because (a) it does not include either future service credits or future salary increases and (b) the measure of the obligation is the same as or similar to the measure of what plan members would receive if they retired today. Those who characterize the unfunded ABO in this way generally contend that the measure would be relevant only in the context of plan settlement or liquidation. Supporters of the unfunded ABO respond that plan settlement or liquidation is not the focus or objective underlying their support of measuring the obligation in this way; rather, the objective is to measure the employer's obligation incurred to date by virtue of events that have occurred to date. Unfunded ABO supporters contend that, in terms of measurement, an employer's obligation to employees should not be less than the present value of the earned benefits that an employer would be obligated to pay if employees terminated employment today, over and above the amount of plan assets accumulated in trust to fund benefit payments. However, their support of the unfunded ABO is not based on any assumption about whether termination or settlement of a particular plan is or is not expected to be imminent (generally assumed not to be the case with governmental plans).

Future Salary Increases Viewed as an Option

17. Another view is that the possibility of future salary increases is similar in some ways to the employer writing an option to the employee. These “options” may be more or less well-defined. For example, a term in the employment agreement stating the employer’s policy for salary increases due to inflation or seniority might be taken as a relatively well-defined option and as indicative that future cost-of-living or seniority increases are highly probable. On the other hand, the possibility that an employee will be rewarded for enhanced productivity or merit if he or she stays might (depending on facts and circumstances) be viewed as a less well-defined option. In this approach to viewing future salary increases, an employer has committed at present to providing future salary increases if an employee continues to provide services and certain conditions are met. An employee has the right to “exercise the option” or options given by the employer by continuing to provide services and, if applicable, meeting the employer’s conditions. Accounting and financial reporting issues related to this approach include whether an option on future salary increases has value in the current period and, if so, whether and how it could be reliably measured.

Discounting Projected Benefits

18. The purpose of using a discount rate is to adjust future amounts for the time value of money—that is, to adjust future amounts to their present-day equivalents. A discount rate may encompass certain risks and rewards, including but not necessarily limited to investment risk or rewards, actuarial risk, and an entity’s own credit risk. Investment risk refers to the risk that investment returns will differ from their estimated return. Investment risk generally correlates, in the pricing of investments, with opportunity for greater rewards in the form of higher returns. Actuarial risk refers to the risk that actuarial assumptions will differ from actual experience. An entity’s own credit risk refers to the credit risk of the sponsoring entity itself (that is, the risk that the entity will not fulfill its obligations).

19. There are different views on the basis that should be applied to determine the discount rate to be used when calculating the present value of projected pension benefits for financial reporting purposes. One way of thinking about differences among these views is in terms of how they incorporate or adjust for investment risk and rewards, actuarial risk, and an employer’s own credit risk in the determination of the discount rate. The following examples illustrate the treatments of these factors in different discount rates that have been proposed or that are required by a standards setter:

- a. *The estimated long-term investment yield for the plan, with consideration given to the nature and mix of current and expected plan investments and the basis used to determine the actuarial value of assets*—This discount rate incorporates the estimated return on plan assets, including estimated earnings over and above a risk-free rate of return (“premium earnings”), based on the current and expected future allocation of plan assets for investment purposes. Being an estimated rate of return, this discount rate does not reflect the risk of variations between estimated and actual outcomes, including the risk that actual returns may fall short of estimates. The rate itself is an actuarial assumption. It incorporates component assumptions about the allocation of plan assets in future years pursuant to a

plan's investment policy and about future investment return experience. This rate does not reflect the credit risk of the employer as plan sponsor, because it is based on long-term estimated asset earnings and is not related to the employer's cost of borrowing.

- b. *A risk-free rate (or yield curve of risk-free rates applied to cash flows with different maturities)*—A risk-free rate is generally approximated by long-term U.S. Treasury obligations or inflation-protected Treasury securities because such securities are guaranteed by the U.S. government and therefore are generally considered to be essentially risk free. A risk-free rate does not include investment risk associated with an allocation of assets that provides an expectation of premium earnings (or the expectation of those premium earnings) or actuarial risk. Because this rate is not a borrowing rate, it does not involve consideration of an employer's credit risk, as such. However, some proponents of the use of a risk-free rate also support adjustment of that rate for an employer's credit rating. This would result in the use of a higher discount rate and the calculation of a lower present value of projected future benefit payments when an employer's credit risk is higher, in order to reflect the diminished value of the promise from the standpoint of plan members or other potential counterparties.
- c. *The employer's borrowing rate*—Because this is a borrowing rate and is not based on the investment of plan assets, it does not involve considerations related to investment risk or rewards and does not involve the use of actuarial assumptions about future investment policy and experience. It does reflect an adjustment for the employer's own credit risk, because it is based on the perceived likelihood that the employer will repay its obligations, in particular, its obligation to employees related to defined pension benefits.
- d. *An average return on high-quality municipal bonds*—A discount rate based on the return on high-quality municipal bonds (as an asset class) also is a borrowing rate. It includes the credit risk that the municipal bond market associates with high-quality municipal bond issues as a whole but does not adjust for entity-specific credit risk. Like the employer's borrowing rate, this rate does not involve the use of actuarial assumptions about future events.

Views on the Use of an Estimated Long-Term Investment Yield

20. Those who believe that the estimated long-term investment yield for the plan should be the basis for determining the rate used for discounting projected pension benefits to their present value for financial reporting purposes offer these reasons:

- a. The present value of projected benefits—from which the unfunded accrued benefit obligation is derived in a funding-based approach to accounting and financial reporting—is integrally related to the way in which plan net assets are invested and, therefore, should reflect the estimated rate of return given the current and expected allocation of plan assets pursuant to the investment policy for each pension plan.
- b. The use of the estimated rate of return is consistent with the orderly accumulation of plan assets through employer and member contributions, combined with the return on plan assets, within the framework of an actuarially developed funding program.
- c. The use of a discount rate that reflects the long-term estimated rate of return on plan assets is consistent with the long-term perspective that is appropriate for financial reporting of governments' pension commitments, because the discount rate (1) generally does not change appreciably in response to short-term changes in investment earnings and (2) is not

dependent on current published discount rates for reference securities that are subject to frequent rate variation.

- d. The development of long-term estimated return assumptions for financial reporting for state and local governmental pensions is appropriately constrained by actuarial practice standards, and the rates commonly used are supported by historical returns on plan assets and are reasonable expectations for the future, despite short-term experience fluctuations, given the size, asset diversification, and long time horizon of public pension plans.
- e. Discounting at the long-term expected rate of return is consistent with the objective of allocating annual required contributions of the employer among financial reporting periods so as to keep employer contributions and annual pension cost relatively level as a percentage of annual covered payrolls—a pattern considered to support interperiod equity. Even though annual required contributions may be affected to some extent by investment gains and losses, the use of the long-term expected rate of return avoids overcharging and overcontributing currently, which could result if risk premiums associated with the plan's investment allocation were not factored into the discount rate.

21. Others believe that the estimated long-term investment yield for the plan is an inappropriate basis for determining the discount rate used for discounting projected pension benefits to their present value for accounting purposes. They believe that using the estimated long-term investment yield:

- a. Effectively treats an investment in higher risk and reward securities as more valuable for financial reporting purposes than an investment in lower risk and reward securities with the same market value. Effectively, the higher estimated return on the higher risk securities is accepted without taking into consideration the greater risk associated with a wider potential dispersion of investment outcomes for those securities.
- b. Results in a mismatching of costs and benefits in current and future periods because incorporating the expectation that premium earnings will occur in future periods into the discount rate effectively reduces employer contributions and demands on taxpayers or revenue providers in the current period. However, the associated investment risk, for which securities with premium earning potential are priced to compensate, is borne by the taxpayers or revenue providers of future periods.
- c. Potentially results in valuing differently the unfunded accrued benefit obligations of two employers that otherwise are equal, based solely on differences in whether and how the employers accumulate and invest plan assets—a matter that should be treated as a separate financing decision.

Views on the Use of a Risk-Free Rate

22. In contrast to those who believe the discount rate should reflect some form of risk premium, others believe that a risk-free rate (or yield curve of risk-free rates applied to cash flows of different maturities) should be used to discount projected pension benefits to their present value for accounting purposes. In their view, the use of a risk-free rate:

- a. Is consistent with the virtually risk-free quality of many state and local governments' defined-benefit pension commitments and the way that financial markets value debt of comparable quality, the closest analogy being bonded debt

- b. Effectively values plan assets, for purposes of calculating an employer's pension obligation, in the way that the financial markets value them—that is, on a risk-adjusted basis—thereby avoiding any accounting incentive to invest in riskier securities in an effort to reduce funding in the short term or to improve the reported funded status of the benefits
 - c. Prevents the transfer of investment risk from current to future taxpayers and the mismatch of the benefits and costs associated with that risk, which is inherent in the use of the long-term estimated rate of return on plan assets when the allocation of assets includes the expectation of premium earnings
 - d. Represents the time value of money without the effects of additional factors that do not impact the amount of future cash payments to plan members
 - e. Values an employer's pension obligation independently of separate decisions that the employer makes with regard to the financing of the obligation, which results in comparable valuation of comparable obligations.
23. Others disagree with the use of a risk-free rate for discounting projected pension benefits to their present value for financial reporting purposes because they believe that:
- a. The use of a risk-free rate as the discount rate does not reflect the actual allocation of plan assets for investment purposes or the estimated return on plan assets given the actual allocation of the assets.
 - b. The objective of reporting an employer's pension obligation at market value, which often underlies the advocacy of using a risk-free rate, is not relevant to financial reporting by state and local governmental employers because (1) the governments themselves, which have the obligations, have no shareholders or equity shares trading in financial markets; (2) the pension plans are assumed to be going concerns; or (3) the pension obligations generally are not terminated or settled in market transactions with third parties.
 - c. The market price of an employer's obligation to provide pension benefits, if calculated using a risk-free rate as the discount rate, does not reflect (1) the expected net cost of that obligation to the employer, given the premium earnings that reasonably can be expected on the investment of plan assets or (2) the value of the pension promise to active plan members, viewed from the long-term perspective of an employee's tenure with the employer.
 - d. The use of a current interest rate on a reference security, or a portfolio of reference securities, such as U.S. Treasury bonds, admits unnecessary volatility into the calculation of the discounted present value of projected pension benefits for financial reporting purposes; the volatility results from short-term rate changes that are unrelated to the terms of the pension commitment and are inconsistent with the long-term perspective of the plan.
 - e. Although there is a risk of fluctuations in investment experience, and consequently investment gains and losses, from year to year, the use of a risk-free discount rate generally would not result in allocating annual required contributions of the employer or annual pension cost in a way that is considered to be consistent with a reasonable expected investment experience over the long term.

Views on the Use of a Borrowing Rate

24. Some believe that the discount rate should be based on a borrowing rate—either the employer’s current or incremental borrowing rate or the interest rate on high-quality municipal bonds as a class. Proponents believe that a borrowing rate is relevant because it represents what an employer would have to pay to borrow the funds necessary to satisfy its unfunded accrued benefit obligation for defined pension benefits. In their view, an employer is in the position of a debtor because it has “borrowed” the amount of the unfunded accrued benefit obligation from employees and will pay it back in the future, after employment, rather than paying employees more compensation currently. Employees are viewed as creditors who have agreed to accept some deferral of compensation in partial exchange for their services to the employer in the current period. The use of a borrowing rate is consistent with what the cost of funds would be if the government had to or chose to finance the accrued benefit obligation by issuing bonds or borrowing from a bank.

25. Some support using the employer entity’s own borrowing rate, which may include a premium to reflect risk related to the credit quality of that entity’s debt. Others believe that it is not appropriate to include an adjustment for the entity’s own credit risk, because the entity’s credit risk does not change the amount that the government ultimately will have to pay to retire the debt. They believe that financial reporting by state and local governments for their liabilities should focus on the governments’ accountability for what they owe—including, in some cases, constitutionally or statutorily established obligations to provide pension benefits—rather than on the perceived value of governments’ liabilities to counterparties or potential counterparties. They do not believe that a perceived decline in the value of a liability to counterparties as the result of a decline in a government’s credit rating should result in the government’s reporting a reduction of the liability and a gain. Some who hold that view instead support the use of the discount rate on high-quality municipal bonds as a class.

26. Some disagree with the use of a borrowing rate as the basis for determining the discount rate because they believe:

- a. A borrowing rate is inconsistent with the estimated growth of plan assets from investment, based on the actual allocation of assets pursuant to the plan’s investment policy
- b. Governmental employers typically fund their pension commitments through an actuarially developed program of contributions that includes a provision for amortizing the unfunded accrued benefit obligation
- c. A borrowing rate is a current rate that is subject to volatility, and therefore its use in measurements for financial reporting purposes would result in reporting short-term fluctuations related to interest rate changes.

Questions

- 4. Should the projection of pension benefits include or exclude the following projected future changes? Why?**
 - a. Automatic COLAs**
 - b. Projected future ad hoc COLAs, in circumstances in which ad hoc COLAs are substantively a part of the employment agreement, as demonstrated by an employer's pattern of practice**
 - c. Projected future salary increases**
 - d. Projected future service credits.**

- 5. What should be the basis for determining the discount rate used for discounting projected pension benefits to their present value for accounting purposes? Why?**
 - a. The estimated long-term investment yield for the plan**
 - b. A risk-free rate (or a yield curve of risk-free rates applied to cash flows of different maturities)**
 - c. The employer's borrowing rate**
 - d. An average return on high-quality municipal bonds**
 - e. Other.**

CHAPTER 5—ISSUES RELATED TO THE USE OF ACTUARIAL METHODS

Introduction

1. This chapter explores actuarial methods that might be considered by the Board for potential use in standards of accounting and financial reporting if, after due process, the Board were to adopt an accounting measurement approach (such as Alternative 1 or Alternative 3 in Chapter 3) that includes the recognition of some components of pension cost as expense of future periods through a process of amortization. Following the discussion of issues, respondents will be asked to respond to a series of questions regarding the use of actuarial cost methods, maximum amortization periods, amortization methods, and methods of determining the actuarial value of plan assets for accounting and financial reporting purposes.
2. In this chapter:
 - a. The term *pension cost* is used in a specific way, to refer to the consumption of an employer's net resources—here meaning assets less liabilities and (or including) the unfunded accrued benefit obligation—associated with compensation for employee services to date.
 - b. It is tentatively assumed for purposes of discussion that the normal cost, or current-period service cost, component of pension cost would be recognized as an expense as employee services are rendered and received by the employer in each financial reporting period under any accounting measurement approach likely to be considered by the Board. Therefore, the issues discussed in this chapter pertain to whether and how some or all *other* components of pension cost, reflected in the unfunded accrued benefit obligation, should be attributed to future periods for expense recognition purposes.
3. The following sections of the chapter address potential actuarial methods for accounting and financial reporting purposes in each of these areas. In each section, the current parameters with regard to acceptable methods are discussed briefly to provide a starting point for considering whether or in what way the current standards might be improved. Each section also includes discussion of potential changes to the current parameters that have been suggested, as well as key reasons why some favor or do not favor particular suggestions.
4. Respondents who favor immediate recognition of pension cost when underlying transactions or other events occur may have concerns about responding to questions on methods of amortizing some components of pension cost. Those with such concerns are encouraged to preface their response with a comment that it is predicated on a possibility they do not favor—that the Board might adopt an approach that includes amortization of some components of pension cost (yet to be deliberated). On the other hand, some respondents may believe that parameters with regard to the selection of actuarial methods should explicitly align amortization for expense recognition purposes with funding objectives. Those who hold that view are encouraged to respond to the questions in this chapter in the context of the accounting objectives and concepts discussed, but to explain their preference for other criteria, if applicable.

Actuarial Cost Methods

Introduction to the Issues

5. The current parameter on actuarial cost methods (paragraph 10d of Statement 27) is that any of six specified actuarial cost methods is acceptable for use in an actuarial valuation for accounting and financial reporting purposes. The acceptable methods are entry age, frozen entry age, attained age, frozen attained age, projected unit credit, and aggregate. The current parameters further require that the actuarial methods (including the actuarial cost method) and the assumptions used for accounting and financial reporting purposes should be the same methods and assumptions used in determining the pension plan's funding requirements, unless a departure from the methods and assumptions used for funding purposes is necessary in order to comply with the parameters for accounting and financial reporting.

6. In a given financial reporting period, the choice of an actuarial cost method affects the *amounts* reported as normal cost, amortization of the unfunded accrued benefit obligation, and annual pension cost or expense. Over the life of a pension plan, the choice of an actuarial cost method affects the *pattern of allocation* of the ultimate total pension cost among periods but not the total itself, which will be the same regardless of the actuarial cost method chosen. The current parameter is based on the Board's conclusion when developing the standards that the use of any of the six permitted actuarial cost methods, consistently applied, would result in a reasonable allocation of pension cost among financial reporting periods for the purpose of expense recognition.

7. Various views have been expressed as to whether the current actuarial cost method parameter should be left unchanged or amended to reduce or expand the number of acceptable methods for accounting and financial reporting purposes. The principal issues discussed in this area are:

- a. The number of actuarial cost methods that should be permitted
- b. The manner in which various methods allocate the present value of projected pension benefits among past, present, and future periods.

Number of Actuarial Cost Methods Permitted

8. Some believe that the number of actuarial cost methods currently permitted and the resulting variations in the measurement of pension information (including annual pension cost and the accrued benefit obligation) reduces the decision usefulness of financial information to report users. Those who hold that view believe:

- a. The provision of accounting policy options, as in the choice of an actuarial cost method, introduces a subjective element into the measurement and financial reporting of pension information, because an employer can control to an extent how it reports the financial effects of its pension commitment by its selection of measurement options.

- b. Employers' use of a variety of actuarial cost methods significantly diminishes the ability of report users to make informed comparisons among governmental employers with regard to the financial effects of their defined benefit commitments.
 - c. It is difficult even for sophisticated report users to interpret the effects of individual governments' choices of actuarial cost methods, given the variety and complexity of methods currently permitted.
9. For these or other reasons, some would favor reducing the number of choices permitted. They believe that reducing the number of acceptable methods would improve the decision usefulness of financial reporting by removing or reducing a source of diminished comparability among employers and by reducing the demands on report users to understand and interpret the relative effects of using one of a variety of actuarial cost methods.
10. Others favor retaining the current options with regard to individual employers' selection of an actuarial cost method for accounting and financial reporting purposes or, in some cases, expanding the number of options. Those who hold that view believe:
- a. The accounting parameter should be flexible in order to accommodate, as much as possible, the funding and accounting policy choices or potential policy choices that individual employers and pension plans may make with regard to the selection of an actuarial cost method.
 - b. The necessity of applying judgment to make actuarial assumptions about future events ultimately would make it impossible to attain complete comparability in pension financial reporting, even if the use of an actuarial cost method, or of actuarial methods generally, was standardized. Moving in the direction of increased consistency by reducing methodology options might mislead some report users into believing that financial reporting *would be comparable*.
 - c. Standards of accounting and financial reporting should focus on enhancing consistent financial reporting by individual employers over time rather than on the comparability of financial reporting among employers.

Allocation of the Present Value of Projected Benefits as Costs of Past, Present, and Future Financial Reporting Periods

11. Among those who favor reducing the number of actuarial cost methods, views and suggestions differ with regard to which methods should be eliminated from use and the number and composition of the method or methods that should be permitted for accounting and financial reporting purposes.
12. One of the principal criteria for consideration when assessing the suitability and usefulness of actuarial cost methods in financial reporting is the manner in which individual methods allocate pension costs to past, present, and future periods. As applied to accounting and financial reporting, that allocation affects (a) the measurement of annual pension cost (expense) and the employer's accrued benefit obligation and (b) the disclosure of the funded status of the plan. Some question the suitability of three of the six actuarial cost methods—aggregate, frozen entry age, and frozen attained age—for accounting purposes in that regard.

13. The Board previously has addressed the limitations of the *aggregate actuarial cost* method for use in accounting and financial reporting. That method does not assign any of the present value of projected benefits to past periods and, as a result, does not provide a measure of the employer's accrued benefit obligation or a basis for disclosing the funded status of the plan. The absence of a reported unfunded accrued benefit obligation sometimes has been misconstrued as meaning that a plan for which aggregate is used always is fully funded. To address the financial reporting limitations of the aggregate method, the Board required that an OPEB plan or employer that uses the method to determine the annual required contribution of the employer to the plan should disclose the approximate funded status of the plan and present a multi-year trend schedule of funding progress using another actuarial cost method—entry age—as a surrogate for the aggregate method. Subsequently, the Board amended the existing standards to extend that requirement to pension plans and employers, as well. However, the use of the aggregate method still is permitted for determining the annual required contribution of the employer.

14. Some would favor eliminating the aggregate actuarial cost method altogether for use in accounting and financial reporting, generally for a combination of the reasons discussed in the preceding paragraph and their belief that the usefulness of pension reporting to users would be improved by reducing the number of options. Others would favor retaining the use of the aggregate method because they believe that the parameters should accommodate the widest possible range of reasonable individual employer policy choices. Those who hold that view believe that the aggregate method should continue to be considered acceptable for use in accounting and financial reporting because it results in significant plan asset accumulation in earlier periods if an employer consistently funds the annual required contribution, especially when compared to the unit credit method and other actuarial cost methods generally.

15. Some also would favor eliminating the frozen entry age and frozen attained age actuarial costs methods from use for accounting and financial reporting purposes. Except for their treatment of an initial “frozen” piece of the total pension obligation, which may diminish over time, the frozen entry age and frozen attained age methods function in the same way as the aggregate method. Accordingly, they believe the frozen methods have essentially the same accounting and financial reporting limitations as the aggregate method, and the same views discussed in regard to retaining or eliminating the use of the aggregate method in paragraph 14 also generally apply to the frozen methods.

16. Another factor considered by some is the relative usage of the six permitted methods. Research indicates that the entry age method is used by approximately three-fourths of large public pension plans, followed by the projected unit credit method (15 percent) so that these two methods together account for almost 90 percent of large public pension plans. Research indicates that the entry age method is used by approximately 85 percent of smaller public pension plans. Among those who favor reducing the number of actuarial cost methods, some suggest limiting the acceptable methods to one or both of entry age and projected unit credit, based on both preponderance of usage and their patterns of allocating pension costs among past, present, and future periods—or suggest requiring the use of the unit credit method without projection of future salary increases. Those who hold that view generally would favor the elimination of the aggregate and frozen methods for reasons discussed previously. Some also believe that the overall benefit of eliminating the infrequently used attained age method would exceed the cost for plans and employers that would be required to change methods. As discussed previously,

others believe that the accounting parameter should include as many methods as possible, in order to accommodate as many individual policy choices in regard to actuarial cost methods as appropriate.

17. If only one method were to be required for accounting and financial reporting purposes, some would suggest requiring the use of the entry age method for these reasons:

- a. Of the two methods most commonly used among those currently permitted, the entry age method is used by several times as many governmental employers and plans. It results in less back-end loading for expense recognition and funding purposes and generally is considered to be the more effective method for accumulating plan assets.
- b. Standardized usage of the entry age method would be consistent with the way that most pension benefits currently are measured and, accordingly, would require fewer employers and plans to change actuarial cost methods for accounting and financial reporting purposes or to use a method different from the one they currently use for funding purposes.

18. Others would suggest requiring the use of the unit credit method for accounting and financial reporting purposes for these reasons:

- a. The unit credit method is more explicitly intended to measure the accrual of pension benefits, in comparison with methods such as entry age that are classified as cost-allocation methods.
- b. Its use would attribute pension cost to periods in a way that would be more nearly representative of the way in which plan members accrue benefits in most pension plans.

Amortization of the Unfunded Accrued Benefit Obligation

Introduction to the Issues

19. From an accounting and financial reporting perspective, the *maximum amortization period* and the *amortization methods* permitted for amortization of the unfunded accrued benefit obligation establish the limits within which the recognition of components of pension cost *other than normal cost* may be attributed to future financial reporting periods.⁴

20. The current parameters establish a *maximum amortization period* of 30 years for amortization of the total unfunded accrued benefit obligation.⁵ The parameters do not specify whether the amortization period should be closed or open, and the glossary of Statement 27 includes definitions of both *closed amortization period (closed basis)* and *open amortization period (open basis)*. Accordingly, both methods are considered permissible under the current

⁴Under current standards and any accounting approach discussed in this Invitation to Comment or likely to be considered by the Board as part of this project, normal cost or service cost is assumed to be recognized as pension expense each period.

⁵The current parameters also establish (a) an *equivalent single amortization period*, or weighted average amortization period, that should be calculated when components of the total unfunded accrued benefit obligation are amortized separately over different periods and that should not exceed the maximum amortization period, and (b) a *minimum amortization period* for the amortization of a significant actuarial gain resulting from a change in the actuarial cost method or the method of determining the actuarial value of plan assets.

parameters and both are used in practice. The closed and open amortization bases differ as follows:

- a. When a closed amortization period is used, the amortization period is a specific number of years—initially 30 years or less—that is counted from a single date and declines over time (by one year each year) to zero.
 - b. When an open amortization period is used, the amortization period either begins again each year (resets each year at the original number of years) or is recalculated at each valuation date. The latter variation is used, for example, when the employer’s actual contribution to the pension plan is established by law or policy. Given that contribution, the actuary recalculates the amortization period, which may increase, decrease, or remain stable, subject to a maximum number of years established by law or policy.
21. The current parameters also permit the use of a variety of *amortization methods*. The total unfunded accrued benefit obligation may be amortized:
- a. As one amount, or components of the total may be amortized separately over different amortization periods, subject to the constraint that the weighted average amortization period (equivalent single amortization period) may not exceed a maximum amortization period
 - b. In level dollar amounts or as a level percentage of the projected payroll of active plan members.
22. The preceding options with regard to amortization period or periods in years, closed or open amortization, and level dollar or level percentage of payroll amortization may be combined in various ways, with each combination affecting accounting measurements differently.
23. Various views have been expressed as to whether the current amortization parameters should be left unchanged or amended to (a) reduce the number of acceptable methods and combinations for accounting and financial reporting purposes or (b) otherwise improve the allocation of components of pension cost other than normal cost to periods for expense recognition purposes. The principle issues discussed in this area are:
- a. Whether and within what limits (maximum amortization periods) recognition of some components of pension cost as expense in future periods should be permitted, and whether different maximum amortization periods should apply to different components (for example, retroactively applied benefit increases and actuarial gains and losses)
 - b. Whether a single amortization basis, either closed or open, should be required
 - c. Whether the maximum amortization period or periods should vary depending on the amortization base and amortization methods chosen, if options are permitted.

Whether and Within What Limit or Limits Attribution of Some Components of Pension Cost to Future Periods Should Be Permitted

24. From an accounting and financial reporting perspective, a key function of actuarial methods is to associate pension cost with past, present, and future periods to support recognition of expense in the period or periods to which it is applicable (as that concept is discussed in

Chapter 3 of this Invitation to Comment). An important issue is *how* pension cost should be associated with periods for that purpose, particularly in resource flows statements that are prepared using the economic resources measurement focus,⁶ for which the conceptual basis for determining applicability to a reporting period is interperiod equity.

25. Views and suggestions differ regarding the specific extent or duration of amortization, if any, that should be permitted for the purpose of attributing components of pension costs other than normal cost to financial reporting periods as expense of those periods. These ideas (not a complete list of possibilities) are discussed in the following paragraphs:

- a. Immediate recognition upon the occurrence of the underlying transactions or other events
- b. Amortization over a maximum of 30 years
- c. Amortization over a maximum of the average remaining service life of active plan members
- d. Amortization of different components of pension cost, such as benefit increases and actuarial gains and losses, over different amortization periods.

Immediate Recognition

26. As discussed in Chapter 3, some believe that all components of pension cost should be recognized as expense or other resource flows at the time that pension transactions and other events occur. Those who hold that view believe the following:

- a. Deferring pension cost that (1) pertains to events that already have occurred and (2) is attributed to past services by an actuarial cost method such as entry age or unit credit inappropriately attributes pension cost to future periods that do not benefit from the services being compensated. Net pension cost should be attributed to the periods that did benefit or—in the case of retroactively applied benefit increases—to the period in which an increase in compensation for past services was granted.
- b. Reporting deferred components of pension cost as expense in resource flows statements of future periods, in conjunction with revenues of those periods, is inconsistent with:
 - (1) The financial reporting objective of helping report users assess whether revenues are sufficient to pay for the services provided each year or whether future taxpayers will be required to assume financial burdens for governmental services provided in past years⁷
 - (2) The notion that the period(s) to which a consumption of net resources is applicable should be determined using the concept of interperiod equity.⁸

27. Others disagree with immediate recognition because they believe that it (a) results in unnecessary volatility in the measurement of pension expense and (b) does not produce useful measures of the contribution of pension expense to the total cost of government services over

⁶Current examples of resource flows statements prepared using the economic resources measurement focus are the government-wide statement of activities; the statement of revenues, expenses, and changes in fund net assets of proprietary funds; and the statement of changes in net assets of fiduciary funds.

⁷Discussed in Concepts Statement 1 and Chapter 3 of this document.

⁸Discussed in Concepts Statement 4 and Chapter 3 of this document.

time, considering that pensions are viewed from the long-term perspective of an employee's career. Those who hold that view believe the following:

- a. The pattern of attribution of the total cost of providing pension benefits to an employee that best reflects annual pension expense over the span of his or her career is one in which expense remains relatively constant over time as a percentage of salary. That is, the total cost of providing pension benefits to an employee would be allocated in such a way that pension expense over time would increase gradually as a function of increases in salary.
- b. Conversely, it would not be decision-useful to allocate total pension cost in a way that reflects that annual pension costs are different in earlier and later years of service, beyond the effects of salary changes over time, because those costs all come from a pension benefit commitment that is most usefully measured from the perspective of an employee's career.

Amortization over a Maximum of 30 Years

28. Some believe that standards of financial reporting should permit all components of pension cost other than normal cost to be recognized as expense over an amortization period not to exceed 30 years. Some who hold that view believe the following:

- a. Attributing the effects of actuarial gains and losses (changes in the *measurement* of the accrued benefit obligation related to the use of estimates and actuarial assumptions) to future periods through amortization results in more useful measures of annual pension cost over time, because it filters short-term fluctuations in experience that are not relevant from a long-term perspective.
- b. Amortization of the financial effects of retroactively applied benefit changes not previously included in pension calculations also is appropriate, because those changes, although associated with past services of retirees or active plan members, have intangible or indirect future benefit to the employer and to taxpayers and other revenue providers by helping to retain existing employees and recruit new employees.
- c. Thirty years is an appropriate maximum amortization period, because it represents the notional length of a full career in government service.

29. Others disagree with permitting all components of pension cost other than normal cost to be amortized over as much as 30 years. As discussed previously, some disagree with amortization generally, regardless of the components to be amortized or the amortization period. However, others disagree with this specific proposal because:

- a. Some believe that the maximum amortization period (30 years) lacks support as a representation of a full career in government service. Others question the relevance of using the length of a full service career, whatever that may be, as a basis for recognition of past service costs in future periods, because those costs already have been incurred, and because the maximum period may be used even if it does not reflect the demographic profile of the active plan membership. For example, if the average remaining service life of employees in a pension plan was 15 years, the use of a 30-year amortization period would result in amortizing pension costs for 15 years after employees' retirement from active service.

- b. The indirect future benefits of retroactively applied benefit increases in helping to retain existing employees and recruit new employees are questioned. Even if such indirect future benefits could be demonstrated to exist in some cases, the association of the increased pension cost created by such benefit increases with past services provides a more direct and objective basis for attributing the incremental pension costs to past periods or to the period in which a benefit increase was given.
- c. The volatility of factors that affect an employer's pension obligation and expense is inherent in pensions, and it should not be an objective of accounting and financial reporting to level the effects of actual experience. A leveled measure of annual pension cost is more subjective, particularly when methodology options are permitted, and that it is difficult to demonstrate that a particular leveled measure of annual pension cost best represents the contribution of pensions to a government's total cost of government services.

Amortization over a Maximum of the Average Remaining Service Life of Active Plan Members

30. Some believe that standards of financial reporting should permit all components of pension cost other than normal cost to be amortized to future periods. However, they would reduce the maximum amortization period from 30 years to the average remaining service life of the active plan membership. Those who would favor amortization over the average remaining service life believe that:

- a. It would result in amortizing the total unfunded accrued benefit obligation over the active members' projected remaining years of service, rather than deferring recognition of some of the associated pension cost beyond the years when the members still would be providing services to the government and its constituents.
- b. Amortizing the effects of benefit increases applied retroactively to past periods of service of active plan members is appropriate because such changes have intangible benefit by improving those plan members' morale during their remaining years of employment.
- c. The concept of interperiod equity supports the recognition of pension costs as expense in financial reporting periods that benefit from those costs through employee services, including the intangible benefit of retroactively applied benefit increases during the remaining years of service of active plan members.

31. Others who favor the amortization of some components of pension cost other than normal cost still would question the idea that amortization of retroactively applied benefit increases, which increase the compensation of retired or active plan members for past services, as expense of future periods is justified by expected intangible or indirect benefits to the government and its constituents in future periods. The expense associated with such benefit increases should be recognized in the period in which an increase is enacted rather than in future periods, even if the incremental accrued benefit obligation is to be *financed* through increased contributions in future periods. Moreover, the increased pension obligation and cost pertain to services already received and do not demonstrably provide additional services to future periods.

Amortization of Benefit Increases and Actuarial Gains and Losses over Different Amortization Periods

32. Some believe that it would be appropriate to establish different maximum amortization periods for different components of pension cost other than normal cost. Some who suggest that approach believe that incremental pension cost created by retroactively applied benefit increases should be amortized over a shorter period—for example, three years—than actuarial gains and losses, or that the cost of benefit increases should not be amortized because the cost pertains to past services and therefore is not applicable to future periods. Some suggest amortization of benefit increases over the average remaining service life of active plan members, based on intangible or indirect future benefit. Those who suggest different amortization periods for different components of pension cost generally would support longer amortization periods for actuarial gains and losses, because it would be appropriate to level short-term experience in order to reduce volatility in the measurement of expense.

Whether a Single Amortization Basis, Closed or Open, Should Be Required

33. Some suggest that the use of a single amortization basis, closed or open, should be required for accounting and financial reporting purposes. However, views differ as to whether the required amortization basis should be closed or open.

34. Those who suggest that closed-basis amortization be required believe that it would result in more easily understood amortization of pension cost other than normal cost to financial reporting periods, because there would be a stated amortization period with a defined beginning and end. By the end of that period, the pension cost to be amortized would be fully recognized as expense in resource flows statements that use the economic resources measurement focus. They believe that when open-period amortization is used, the interpretation of what the reported amortization period signifies may not be clear to report users.

35. Others favor the use of open-period amortization because it (a) avoids the abrupt changes that could occur in the amounts of expense recognized in closed-period amortization as individual components of pension cost are fully amortized, (b) accommodates amortization of the total unfunded accrued benefit obligation as a single amount, and (c) better accommodates a type of obligation that continually changes as the result of transactions and other events over time. Because closed-period amortization would require that the components of the total unfunded accrued benefit obligation be amortized separately, the use of that method would increase the complexity of actuarial valuations for accounting purposes and should not be required.

36. A specific item of concern to some is the use of a form of open amortization in which the amortization period resets each year, in conjunction with certain other permitted amortization policy choices such as setting the amortization period at the maximum and using level percentage of payroll amortization. With some combinations, a condition can occur in which the annual required contribution of the employer is insufficient to cover interest on the unfunded accrued benefit obligation, resulting in an increase in the obligation. Some believe that this form of amortization is not a problem, because even though the total unfunded accrued liability may

be increasing in current dollar terms as a result of the calculation of annual required contributions, the employer(s) will be better off in relative terms so long as the unfunded accrued benefit obligation is decreasing as a percentage of the annual covered payroll of active plan members. Others believe that this form of amortization is a problem when viewed in the context of accounting, because the current parameters make it possible for an employer to defer indefinitely the recognition of some pension cost simply by adopting a particular set of accounting policies with regard to amortization. Differing views as to what to do about combinations of amortization methods that have these effects include (a) carrying forward the current amortization without change, (b) requiring the use of closed-period amortization, or (c) permitting or requiring open-period amortization, but amending the parameters to prevent the use of amortization policy combinations that could result in indefinite attribution of some pension cost to future periods.

Whether the Maximum Amortization Period(s) Should Vary Depending on the Amortization Basis and Methods Chosen, If Options Are Permitted

37. Some believe that the decision usefulness of the amortization period as an indicator of the condition of a defined benefit pension plan is questionable, because the same amortization period may correlate with significantly different levels of employer funding effort depending on the amortization methods used. For example, they believe that the implications of choosing closed or open amortization and level dollar or level percentage of payroll amortization could be so significant in some cases as to make two employers' disclosures that their pension plans have the same amortization periods potentially misleading. Those who hold that view believe that the problem should be corrected by amending the parameters to calibrate the maximum amortization period based on the amortization methods chosen. For example, the maximum amortization period might be 20 years if open-period amortization was used, or 30 years if closed-period amortization was used.

Method of Determining the Actuarial Value of Plan Assets for Accounting and Financial Reporting Purposes

Introduction to the Issues

38. In current accounting and financial reporting, plan assets are reported at their fair value at the financial report date in the statement of financial position issued by state and local governmental pension plans. However, both plan and employer accounting and financial reporting use another measure, the actuarial value of plan assets determined in conformity with current parameters, for two purposes:

- a. The actuarial value of plan assets is used in determining the amortization component of the annual required contribution of the employer, and thus in measuring annual pension cost, because the unfunded accrued benefit obligation is determined by subtracting the actuarial value of plan assets from the accrued benefit obligation.
- b. The actuarial value of plan assets and metrics including or developed from the actuarial value of plan assets (the unfunded actuarial accrued liability and the funded ratio) are integral parts of the disclosure of the funded status of the plan and the presentation of funding progress information as required supplementary information.

39. The current parameters require that the actuarial value of plan assets should be determined using methods and techniques consistent with the portfolio profile, the investment return assumption, and other assumptions used in determining the actuarial present value of total projected benefits, as well as current Actuarial Standards of Practice for asset valuation when measuring pension obligations. Accordingly, the parameters state that the actuarial value of plan assets generally should be market related. In practice, this standard generally is applied by using techniques that average asset values by amortizing the effects of short-term appreciation and depreciation in fair values over several years (most commonly, three to five years). The Basis for Conclusions of Statement 25 includes a comment in regard to the same parameter that the use of a market related value for plan assets could encompass the use of market values. However, it qualifies that current market values should not be used for purposes of measuring the annual required contribution and the funded status of the plan, if their use “would cause funded status and the ARCs for successive periods to fluctuate in a manner that would have little or no meaning from a long-term perspective.”

40. The issue discussed in this section relates to the method that should be used to determine the actuarial value of plan assets. The context of the issue is assumed to be limited to the potential use of the actuarial value of plan assets in an accounting approach that includes amortization of some components of pension cost using actuarial methods.

Views Regarding the Method of Determining the Actuarial Value of Plan Assets

41. Those who seek to reduce short-term volatility in measurements of the accrued benefit obligation as much as possible from year to year generally favor the use of average market value techniques in determining the actuarial value of plan assets. They believe these techniques produce consistent measures of the obligation and the assets for purposes of measuring the net unfunded accrued benefit obligation, the annual required contribution of the employer, and the funded status of the plan. Those who hold that view believe that the use of techniques that take current market value increases and decreases into account over several years achieves an appropriate balance between acknowledgement of a security’s market value at the time of the actuarial valuation and attempting to avoid volatility in reported measures as a result of market fluctuations generally expected to have no long-term significance. Others disagree with the use of averaging techniques for asset valuation purposes, as they disagree with amortization of pension cost, consistent with the view that pension liabilities and assets should be reported at their fair values, and that changes in the unfunded accrued benefit obligation should be recognized as the underlying transactions and events occur.

42. Some believe that the use of an averaged market related actuarial value of plan assets in funded status disclosures and in multi-year funding progress schedules (a) is appropriate from a long-term perspective, (b) acknowledges but does not over-emphasize current market value fluctuations, and (c) may help to reduce the risk of overreaction to both favorable and unfavorable current market conditions on the part of report users. Others believe that another measure of funded status using the fair value of plan assets should be disclosed, because the actuarial value of plan assets produced by an averaged-market-value method will always trail changes in market values and therefore does not represent the assets currently available to fund the accrued benefit obligation.

43. Some believe that the parameters should be amended to provide more specific standards or limits with regard to the use of asset averaging techniques in determining a market related value of plan assets. They believe that would provide more objectivity and comparability to the measurement process. Others believe that the more principles-based current parameter provides sufficient guidance and desirable flexibility with regard to methodology.

44. Among those who would favor a more specific parameter, views differ with regard to the criteria that should be established for the use of techniques that spread the effects of market value gains and losses over more than one year. Some believe that such techniques should be constrained by introducing (a) a maximum number of years over which current market value changes could be taken into consideration or (b) a corridor limiting the degree to which the actuarial value of plan assets could differ from the current market value of the assets. Others believe that no constraints should be placed on the ability of practitioners to develop techniques that attempt to level pension expense from year to year.

Questions

6. If, after due process, the accounting measurement approach adopted by the Board for pensions were to be one of those discussed in Chapter 4 that includes the amortization of some components of pension cost for purposes of recognition of an employer's pension expense:

- a. Which *actuarial cost method or methods* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?
- b. What should be the *maximum amortization period or periods* permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?
- c. Should *different maximum amortization periods* be set for different types of changes to the unfunded accrued benefit obligation? Why or why not?
- d. If you answered yes to Question 6c, what should be the *maximum amortization period for benefit changes applied retroactively to past periods of service* that were not substantively a part of the employment agreements that established the compensation for services in those periods or were not previously included in the projection of pension benefits? What should be the maximum amortization period for *actuarial gains and losses*? Why?
- e. Which *amortization method or methods* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?
- f. What method or methods of determining the *actuarial value of plan assets* should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?

CHAPTER 6—ACCOUNTING BY EMPLOYERS IN COST-SHARING PLANS

Introduction

1. This chapter discusses accounting and financial reporting requirements for employers in cost-sharing multiple-employer pension plans (cost-sharing employers) in contrast with the accounting and financial reporting requirements for employers in single-employer and agent multiple-employer plans (sole and agent employers). Views are presented of those who believe that there should be accounting and financial reporting differences and those who believe that there should be no differences. At the end of this chapter, a question is asked regarding whether the relationship of cost-sharing employers to their pension plans is sufficiently different *in economic substance* from the relationship of sole and agent employers to their pension plans to support a continuation of current accounting and financial reporting differences for cost-sharing employers.

2. A *cost-sharing multiple-employer plan* is generally viewed as a single plan with pooling (cost-sharing) arrangements for the participating employers, in which all risks, rewards, and costs, including benefit costs, are shared and are not attributed individually to the employers. Because benefit obligations and the assets contributed to the plan by all employers are pooled, a single actuarial valuation covers all plan members, and the same contribution rate (or rates) applies for each employer. By contrast, an *agent multiple-employer plan* is viewed as an aggregation of single-employer plans with pooled administrative and investment functions, in which separate accounts are maintained for each employer's contributions and benefits and separate actuarial valuations are performed for each individual employer's plan.

Distinctive Accounting and Financial Reporting Requirements for Cost-Sharing Employers

3. Table 6.1 summarizes the principal differences between the current accounting and financial reporting requirements for sole and agent employers and for cost-sharing employers:

**Table 6.1: Comparison of Current Requirements for Sole and Agent Employers
and for Cost-Sharing Employers**

| | Sole and Agent Employers | Cost-Sharing Employers |
|---|---|---|
| Basis for measurement of expense | Annual pension cost, which includes normal cost and amortization of unfunded past service costs | An employer's contractually required contributions to the plan for the employer's financial reporting period, regardless of how the amounts to be contributed were determined (for example, by statute, contract, actuarial funding methodology, or estimate of pay-as-you-go requirements) |
| Liability recognized by the employer | The net pension obligation (cumulative difference between amounts expensed and amounts actually contributed to the plan) | Contractually required contributions that have not yet been paid to the plan |
| Reporting of information about funded status and funding progress of benefits the employer has promised to employees as compensation for services | <p>Disclose the funded status of the benefits, including the total and unfunded accrued benefit obligation, in notes to the financial statements</p> <p>Present a required supplementary schedule of funding progress, including the total and unfunded accrued benefit obligation</p> | Disclose to employer financial report users where to access a copy of the plan financial report in order to obtain funded status and funding progress information, including the total and unfunded accrued benefit obligation, <i>for the multiple-employer plan as a whole</i> . Because the employer has pooled its benefit obligation with those of other employers, no benefit obligation is imputed to each employer separately. |
| Reporting of information comparing amounts the employer has contributed to the plan to annual pension costs | <p>Disclose information about funding policy in notes to the financial statements, including the required contribution rate pertaining to the employer and, if the rate differs significantly from the ARC, how the rate was determined</p> <p>Disclose annual pension costs for the current year and the two preceding years and the percentages of annual pension costs contributed by the employer each year, in notes to the financial statements</p> | <p>Disclose information about funding policy in notes to the financial statements, including the required contribution rate pertaining to the employer and how it was determined, the required contributions in dollars, and the percentage of the required contributions contributed for the current year and the two preceding years</p> <p>Disclose to employer financial report users where to access a copy of the plan financial report in order to obtain information about the ARC and the percentage of the ARC recognized by the plan from contractually required contributions <i>from all employers</i> for each of the past six plan financial reporting periods</p> |

4. Factors considered by the GASB in developing accounting requirements for cost-sharing employers that are different from those for sole and agent employers included:
 - a. That the amounts that cost-sharing contributors are required to contribute frequently are determined by statute, and payment of those amounts is required

- b. That if expense were measured in any other amount, a cost-sharing employer frequently would have no means of contributing more or less in order to contribute the amount recognized as expense
 - c. That the obligations of employers in a cost-sharing plan were considered different from those of sole or agent employers, because in a cost-sharing plan:
 - (1) The obligations are pooled rather than attributed to specific employers that are individually responsible to fund their own obligations, and no part of the collective obligations is directly attributable to any single employer
 - (2) A single actuarial valuation is performed and all employers are assessed the same contribution rate, which for individual employers may be higher or lower than the rate that would result if separate actuarial valuations were performed of each employer's obligations
 - d. That the obligation of cost-sharing employers is limited to paying their contractually required contributions, and the employers generally have little or no control over the determination of the amounts assessed or, by implication, over the adequacy of those amounts to fund the benefits or the funded status of the plan.
5. Nevertheless, the users of cost-sharing employers' financial reports need information about the cost of employers' commitments to provide benefits to plan members and the extent to which employers' contractually required contributions cover the cost. To address that need, current standards require that *cost-sharing pension plans*, like plans of other types, present schedules of funding progress and employer contributions compared to the ARC and disclose the current funded status of the plan in the notes to the plan financial statements. Cost-sharing employers are required to disclose where to access a copy of the plan financial report to obtain that information.

Views Regarding the Requirements for Cost-Sharing Employers

6. Views differ as to whether the accounting and financial reporting requirements specific to cost-sharing employers appropriately account for employers' pension costs and obligations and provide users of their financial reports with decision-useful information. The following paragraphs discuss three views on the matter.

Current Measurement, Recognition, and Disclosure Requirements Appropriately Account for the Pension Cost and Obligation of an Employer in a Cost-Sharing Plan

7. Some believe that the current approach, based on a cost-sharing employer's contractually required contribution to the plan, appropriately measures and recognizes an employer's pension cost and obligation given the nature of a cost-sharing plan. They consider that the information about the cost of pension benefits, funded status, and funding progress is appropriately disclosed for the plan as a whole in plan financial reports. Those who support the current approach generally believe:
- a. By pooling pension benefit obligations and assets, the current approach accurately reflects that cost-sharing employers have effectively transferred their respective individual obligations, along with the fiduciary responsibility to see that those obligations are funded, to the trustees and administrators of the plan.

- b. Imputing a part of the collective unfunded accrued benefit obligation to an employer in a cost-sharing plan would be arbitrary and not supported by the cost-sharing arrangement itself or by the practice, consistent with that arrangement, of having only a single actuarial valuation performed for the multiple-employer plan as a whole.
- c. The financial obligation and cost of a cost-sharing employer is encompassed in the employer's obligation to pay the contractually required contributions assessed by the plan for each financial reporting period.
- d. The reporting of financial information about pension benefit costs, funded status, and funding progress is appropriately located in the report of the pension plan. This is appropriate because the collective unfunded accrued benefit obligation and the responsibility to see that it is funded reside with the plan.
- e. Considering the number of employers that often participate in cost-sharing plans and the relatively small size of many of the employers, the most cost-effective approach to financial reporting is a single actuarial valuation for the cost-sharing plan as a whole, reporting actuarial information in the plan financial report alone, and basing employers' recognition and measurement on the contractually required contribution amounts billed by the plan.

Current Measurement and Recognition Requirements Are Appropriate, but Additional Disclosures by Cost-Sharing Employers Are Needed

8. Others agree that the present approach appropriately measures and recognizes cost-sharing employers' pension costs and obligations given the nature of cost-sharing plans. However, they believe that additional disclosures are needed in employers' financial reports to help report users assess (a) the financial effects of employers' commitments to provide pension benefits to their employees through the plan and (b) the adequacy of the contractually required contributions assessed by the plan and paid by the employers to cover the cost of those commitments. Additional disclosures could include the number of participating employers, the number of employers that made their required contributions, the dollar amounts of the contributions, and other information about the funded status and progress of the plan. Those who hold this view cite the following factors:

- a. Although benefit obligations in a cost-sharing multiple-employer plan are pooled, ultimately the plan depends on the participating employers for the residual contributions needed, in addition to member contributions and investment earnings, to fund promised pension benefits.
- b. If additions to plan net assets from contractually required contributions have differed significantly from the ARC, then those differences are indicative of the potential level of contribution demands that the plan will need to make on employers in future periods. This information is relevant to users of employers' financial reports.
- c. The funded status of the plan as a whole also is indicative of the potential level of contribution demands that the plan will need to make on employers in future periods and, therefore, also is relevant to users of employers' financial reports.
- d. Disclosing the percentage of contractually required contributions paid, as cost-sharing employers currently are required to do, addresses only whether an employer has paid all of the amounts billed by the plan. It does not, however, provide information about the

adequacy of those amounts to fund the benefits or the funded status and funding progress of promised benefits.

- e. Requiring users of a cost-sharing employer's financial report to obtain a copy of a second report (the plan financial report) in order to obtain the additional information they need to assess the financial implications of the employer's pension commitment reduces the decision usefulness of the employer's report and may discourage some users from obtaining the needed information.
- f. Additional requirements to disclose information about employer contributions and funded status/funding progress potentially could be designed to provide information for the plan as a whole, or for an employer's estimated proportionate part of the plan, without requiring separate actuarial valuations for each employer.
- g. The basis for determination and billing of contractually required contributions to a cost-sharing plan generally provides a reasonable basis for estimating each employer's proportionate part of the collective obligations of the plan.

A Cost-Sharing Employer Has a Long-Term Pension Obligation Based on the Employment Exchange and Should Measure and Recognize Its Obligation and Expense in a Manner Similar to That for Sole and Agent Employers

9. Others hold the view that, notwithstanding the provision of pension benefits through the mechanism of a cost-sharing multiple-employer plan, a cost-sharing employer's pension obligation and expense are rooted in the same employment exchange of salaries and benefits for employee services in which sole and agent employers engage. Accordingly, there is no sufficient *difference in economic substance* based on plan design that would justify a fundamentally different approach to accounting and financial reporting by cost-sharing employers. Those who hold this view cite the following arguments:

- a. A cost-sharing employer—like all employers that commit to provide defined pension benefits to their employees as part of the total compensation for services—incur a long-term benefit obligation (accrued benefit obligation) to its employees for the promised benefits.
- b. The employers in a cost-sharing plan should either:
 - (1) Not report in a manner that suggests (a) they have transferred their respective obligations to the plan or (b) the plan has become the sponsor of the benefits or has relieved employers of their obligations to their employees, because the plan remains dependent on contributions from the employers for residual funding of the collective benefits
 - (2) Report long-term liabilities to the plan in recognition of their respective commitments to contribute to funding of the collective benefits, in exchange for the plan's assumption from individual employers of the benefit obligations to plan members.
- c. Either way, a cost-sharing employer should report its estimated proportionate long-term obligation related to its promise to provide pension benefits to its employees in retirement, and its pension expense, in a manner generally consistent with the requirements for sole and agent employers (with adaptation as necessary with regard to measurement).
- d. Additional requirements to measure, recognize, and disclose obligation, expense, and funded status and funding progress information in reporting by individual cost-sharing

- employers potentially could be designed to provide information for an employer's estimated proportionate part of the plan without requiring individual actuarial valuations.
- e. The basis for determining and billing for contractually required contributions to a cost-sharing plan generally provides a reasonable basis for estimation of each employer's proportionate part of the collective obligations of the plan.

Question

7. Does the relationship between a cost-sharing employer and the cost-sharing multiple-employer plan in which it participates *differ enough in economic substance* from the relationship that a sole or agent employer has with the plan in which it participates *to support different requirements with regard to liability and expense recognition*? Which of the following views best represents your view, and why?

- a. The relationship does differ in economic substance, and current measurement, recognition, and disclosure requirements appropriately account for the pension cost and obligation of an employer in a cost-sharing plan.**
- b. The relationship does differ in economic substance, and current measurement and recognition requirements are appropriate; however, additional disclosures by cost-sharing employers are needed.**
- c. The relationship does not differ in economic substance; a cost-sharing employer has a long-term pension obligation based on the employment exchange and should measure and recognize its obligation and expense in a manner similar to that for sole and agent employers.**

CHAPTER 7—ISSUES SPECIFIC TO REPORTING BY PLANS

Introduction

1. Two questions pertaining to accounting and financial reporting by *defined benefit pension plans* are posed in this chapter. The first is whether the liability for pension benefits to be *recognized in the plan's statement of financial position*⁹ in regard to pension benefits should be (a) those benefits that currently are due and payable to members of the plan or their beneficiaries or (b) the full accrued benefit obligation, however measured. The second is whether a defined benefit pension plan should present a *statement of changes in the unfunded accrued benefit obligation* as a basic financial statement of the plan.
2. An underlying issue is to determine how the nature of a pension plan *as a financial reporting entity* should be interpreted within the context of developing plan financial reporting standards to address the objectives of accountability and decision usefulness, including interperiod equity as discussed in Chapter 1. That is, what should be the focus of the financial statements and other information presented in plan financial reports, and how should plan financial reporting relate to financial reporting by participating employers? Paragraphs 3–7 of this chapter provide background information that sets the context for considering the issues. The discussions of alternative views on the issues begin with paragraph 8.

The Employer-Plan Relationship

3. In considering financial reporting issues related to pensions, it is helpful to begin by taking into account the relationships among four primary parties associated with public pension plans—employer, employees, pension plan trustees, and taxpayers or other resource providers—in terms of their interests or roles with regard to defined pension benefits. Key elements of the Board's understanding may be summarized as follows:
 - a. Defined pension benefits are a part of the total compensation provided by employers in exchange for employee services. That is, the primary transaction that creates pension benefits is between an employer and its employees, and pension benefits are part of the contractual price of obtaining employee services.
 - b. For the employer government and its taxpayers or other resource providers, the cost of employee services each period (including the employer's cost related to pension benefits) is a part of the total cost of the governmental services that a government provides to its citizens or other constituents.
 - c. The pension plan trustees function in a fiduciary role that is instrumental to the financing and delivery of pension benefits by, among other functions, accumulating and investing assets to fund the benefits promised by the employer and administering the payment of benefits to retired employees and their beneficiaries when due in accordance with the terms of the plan.

⁹*Statement of financial position* is a generic term used in Concepts Statement 3 to describe the class of financial statements that report on “the state or status of assets, liabilities, and residual balances at a moment in time” (footnote 7). Under current standards for reporting by pension plans, this financial statement is titled *statement of plan net assets*.

The Current Model

4. Understanding the current model for plan reporting offers a context in which the broader issues about the objectives of plan reporting can be considered. This section (paragraphs 4–7) is intended to establish that context.

5. The reporting framework for pension plans adopted in Statement 25 was developed as a way of reflecting the plan’s role in the relationships described in paragraph 3 and its responsibilities, which are carried out under direction by the plan’s trustees. The reporting standards were developed with the intent to meet the information needs of diverse user groups including, for example, plan members and their representatives, legislative and executive officials of the plan sponsor, participating employer(s), plan oversight bodies, and the plan’s board of trustees or other governing body. The reporting framework includes:

- a. Current financial information about plan assets, liabilities, net assets, and financial activities that add to or deduct from plan net assets
- b. Actuarially determined information, reflecting a long-term perspective, about the funded status of the plan and the progress being made in accumulating sufficient assets to pay benefits when they come due.

6. Within this framework, two financial statements focus on reporting information relevant to accountability for plan trustees’ *stewardship (custody and management) of pension plan assets* entrusted to their care:

- a. The *statement of plan net assets* focuses on the composition and current value of plan assets, plan liabilities, and the difference between those two elements. A plan is required to recognize a liability for member benefits when and to the extent that benefits become currently due and payable by the plan in accordance with the plan terms. The excess of plan assets over plan liabilities is captioned *plan net assets held in trust for pension benefits* (that is, for pension benefits that are not yet currently due and payable).
- b. The *statement of changes in plan net assets* provides information about the principal year-to-year changes in the plan net assets held in trust for pension benefits, in order to assist users in assessing the extent to which the net change is attributable to investment performance, contribution levels, benefits paid or payable, or other factors.

7. In addition, defined benefit pension plans are required to:

- a. Disclose funded status information—including the total accrued benefit obligation, the actuarial value of plan assets, and the unfunded accrued benefit obligation, all calculated in conformity with parameters for actuarial valuations performed for financial reporting purposes—in notes to the financial statements.
- b. Present as required supplementary information (1) a multi-year schedule depicting funding progress (changes in funded status) over time and (2) a multi-year schedule of employer contributions, in which the annual required contributions of the employer(s) are compared to actual employer contributions to the plan. Plans also are required to disclose, in notes to the required schedules, any *factors that would significantly affect report users’ identification of trends* regarding funding progress or employer contributions. Examples of

such factors include changes in benefit provisions, the size or composition of the population covered by the plan, or the actuarial methods and assumptions used.

Two Views Regarding Recognition of a Liability in Relation to Benefits

Recognize a Liability for Benefits Currently Due and Payable

8. Some believe that the liability for benefits that currently are due and payable as of the financial report date is the benefit liability that should be recognized in financial statements of a defined benefit pension plan. Those who hold this view believe:

- a. The approach taken in Statement 25 appropriately casts plan financial reporting in terms of accountability reporting by pension plan trustees and administrators regarding their stewardship of plan net assets.
- b. The elements of the statements of plan net assets and changes in plan net assets, as currently required (including a liability for benefits currently due and payable) are those that are relevant to the objective of reporting on trustees' and administrators' stewardship of contributions received, investments of plan assets, and disbursements of plan net assets.
- c. From a stewardship standpoint, benefits that currently are due and payable fit the definition of liabilities in Concepts Statement 4 as "present obligations to sacrifice resources that the government has little or no discretion to avoid." Conversely, it is doubtful that plan trustees or administrators would be legally responsible for the payment of accrued benefit obligations *in excess of the plan assets* in a plan that was less than fully funded.
- d. The unfunded accrued benefit obligation (the accrued benefit obligation, net of plan assets) is an obligation of the *employer*, arising from the terms of the employer's commitment to provide defined pension benefits as part of the total compensation in exchange for employee services. If recognized as a liability, the unfunded accrued benefit obligation should be recognized in employer financial statements.
- e. In the context of plan reporting, the accrued benefit obligation does not constitute a liability of the pension plan (trust) or its trustees or administrators and as such should not be *recognized* in the plan's statement of net assets. However, it does establish a funding target or benchmark for assessing funding progress, and for that reason its *disclosure* or alternative financial statement presentation may be useful to place plan net assets in context.

9. Others do not agree, because they believe that recognizing a liability only for benefits that currently are due and payable omits essential information about long-term benefit liabilities that would be necessary, in their view, to make the plan financial statements complete.

Recognize a Liability for the Accrued Benefit Obligation

10. Some believe that plan financial statements should present a statement of plan net assets that would include both the plan net assets held in trust for pension benefits (as presently reported) and the accrued benefit obligation for pensions arising from the employment exchange. This should be accompanied by a change statement that would include changes both in the plan net assets and in the accrued benefit obligation. Those who hold this view believe:

- a. The accrued benefit obligation represents, in effect, the reason for accumulating plan net assets, and is a measure (as of the financial report date) of the liability that plan net assets are being accumulated to pay for.
 - b. Recognizing plan net assets apart from the accrued benefit obligation moves financial reporting of information about assets and changes in net assets away from its intended purpose. This results in reporting half of what they see as a complete depiction of the financial status of a pension plan.
 - c. To enhance the decision usefulness of plan financial reporting, the plan financial statements should be structured as statements of *the defined benefit pension arrangement* as a whole, including:
 - (1) The accrued benefit obligation, recognized as a liability of the plan for financial reporting purposes, and transactions and other events that create or affect the amount of that obligation
 - (2) The accumulation of assets in a pension trust to fund the payments of benefits as they become currently due and payable.
11. Others disagree, because they believe:
- a. The proposed focal point of plan financial reporting—the defined benefit pension *arrangement*—is more of an abstract concept around which some wish to construct a particular set of financial statements than a financial reporting entity (for example, plan trustees) that issues financial statements to report the effects of a set of transactions and other events for which it is accountable.
 - b. The accrued benefit obligation pertains to the employer and, to the extent not funded, should be recognized as a liability of the employer. It is not a liability of the plan or its trustees or administrators and should not be recognized as a liability in plan financial statements.

Views Regarding Presentation of a Statement of Changes in the Unfunded Accrued Benefit Obligation

12. This chapter also presents for consideration a question related to financial reporting of changes in the unfunded accrued benefit obligation for pensions. The illustrative examples of pension-related transactions and other events in Chapter 3 indicate that, in the context of pension accounting and financial reporting by employers, the unfunded accrued benefit obligation is affected by:
- a. Transactions over which employers or plan sponsors generally have control, including contributions to the pension plan and benefit changes
 - b. Other events that result in valuation gains and losses, including variances between demographic and economic assumptions used in actuarial valuations performed for financial reporting purposes and the actual experience of the plan.
13. Respondents are asked to consider the idea of including a statement of changes in the unfunded accrued benefit obligation as part of the basic financial statements in plan financial reports, as a method of communicating the quantified effects of such transactions and other

events. Arguments for and against the following three views are discussed in subsequent paragraphs:

- a. The view that the accrued benefit obligation should be recognized as a plan liability and that the statement of changes in plan net assets should be made more robust to capture the changes in the liability. This view is discussed in paragraph 14, and opposing arguments are discussed in paragraph 15.
- b. The view that a statement of changes in the unfunded accrued benefit obligations should be added as a third plan financial statement. This view is discussed in paragraph 16, and opposing arguments are discussed in paragraph 17.
- c. The view that there should be no requirement to include information about changes in the unfunded accrued benefit obligation in plan financial statements in any form. This view is discussed in paragraphs 18 and 19, and opposing arguments are discussed in paragraph 20.

The Accrued Benefit Obligation Should Be Recognized as a Plan Liability, and Changes in the Accrued Benefit Obligation Should Be Included in a More Comprehensive Statement of Changes in Plan Net Assets

14. As discussed in paragraph 10, some believe that the accrued benefit obligation for pensions should be recognized as a liability of defined benefit pension plans, under a financial reporting model that might be characterized as presenting a statement of plan net assets of the pension arrangement as a whole. If so, the plan financial statements would encompass both the employer's commitment to provide pension benefits and the accumulation of plan assets to fund payment of the benefits. Because both plan assets and the accrued benefit obligation would be included in the statement of plan net assets, the accompanying statement of changes in plan net assets would include additions and deductions resulting from transactions and other events that affect both plan assets and the accrued benefit obligation. An advantage of this reporting is that it would accomplish the objective of recognizing changes in the unfunded accrued benefit obligation without the need for an additional financial statement.

15. Others disagree with the preceding view, because they believe that the unfunded accrued benefit obligation is a liability of the employer; accordingly, they do not agree with reporting the accrued benefit obligation as a liability of the plan. Some support an alternate requirement that plans report information about changes in the unfunded accrued benefit obligation as a separate financial statement, in order to make clear that the accrued benefit obligation is not a part of plan net assets (the view discussed in paragraph 16). Others do not believe that plans should report information about changes in the unfunded accrued benefit obligation at the financial statement level (the view discussed in paragraphs 18 and 19).

An Additional Statement of Changes in the Unfunded Accrued Benefit Obligation Should Be Included in Plan Financial Reporting

16. Some advocate including a third basic financial statement in plan financial reports—a statement of changes in the unfunded accrued benefit obligation—in addition to the statements of plan net assets and changes in plan net assets as presently constituted. They support adding the new financial statement because they believe:

- a. Information about the unfunded accrued benefit obligation is essential—along with information about plan net assets held in trust for payment of the benefits reflected by that obligation—in order to present a complete picture of the economic condition of defined benefit pension plans.
 - b. A separate statement of changes in the unfunded accrued benefit obligation that does not articulate with the statements of plan net assets and changes in plan net assets as presently constituted is appropriate, in order to underscore that the unfunded accrued benefit obligation is an obligation, or a liability, of the employer(s), rather than of the plan.
 - c. Prominent financial reporting of quantified information about changes in the unfunded accrued benefit obligation (1) is essential for accountability in regard to transactions such as employer contributions to the pension plan and retroactively applied benefit changes, (2) would enhance the decision usefulness of plan financial reports, and (3) would provide information helpful in assessing the extent to which interperiod equity has been maintained in regard to pensions.
 - d. Groups and individuals interested in information about defined pension benefits frequently look to the pension plan and to plan financial reports for information derived from actuarial valuations.
17. Others disagree with this view, but individual reasons for disagreement differ:
- a. Some believe that the proposal to include a statement of changes in the unfunded accrued benefit obligation supports their view that the accrued benefit obligation should be recognized as a liability in plan financial statements, discussed in the preceding section. If that were done, changes both in pension assets and in the pension liability would be recognized in a more robust change in net assets statement without the need to create an additional financial statement of changes in a measure (the unfunded accrued benefit obligation) that would not correspond to information recognized in other plan financial statements.
 - b. Others do not believe that the proposed additional financial statement is necessary or appropriate in plan financial reporting, for reasons discussed in the following section.

A Statement of Changes in the Unfunded Accrued Benefit Obligation Should Not Be Included in Plan Financial Reporting

18. Some disagree with the idea that a basic financial statement of changes in the unfunded accrued benefit obligation should be included in plan financial reporting, because they believe:
- a. The current requirement to include notes to the required schedules of funding progress and employer contributions when a significant change has occurred addresses the matter adequately.
 - b. If the financial reports of some plans *do not include* notes to the required schedules regarding transactions or other events that have a significant effect on the unfunded accrued benefit obligation, or *do not include the quantified effects* of such changes, then that is an issue of lack of clarity of, or noncompliance with, the standards related to required supplementary information. That lack of clarity or conformity should be addressed by education to raise the awareness of financial report preparers or by amending the requirement to make it more specific.

19. Others support the idea of a statement of changes in the unfunded accrued benefit obligation, but oppose its inclusion in pension plan financial reports. They believe that the accrued benefit obligation is an obligation or liability of the employer, rather than the plan; accordingly, a statement of changes in the unfunded accrued benefit obligation, if required, would be more appropriately included in employer financial reports.

20. Those who disagree with the view discussed in paragraph 18 do so because they believe that information about the financial effects of transactions and other events that affect the unfunded accrued benefit obligation is of such importance to users of plan, as well as employer, financial reports that it should be recognized in a basic financial statement. Views differ as to whether the basic financial statement should be the statement of changes in plan net assets or a separate statement. They do not believe that current requirements to disclose factors affecting trends in funding progress or employer contributions in notes to required supplementary information are sufficient to ensure adequate reporting, or that required supplementary information is the appropriate communication method for the information, even if current requirements were amended to require more detailed notes about the quantified effects of changes.

Questions

8. Which of the following should a pension plan report as its liability in regard to pension benefits, and why?

- a. A liability for benefits currently due and payable**
- b. The accrued benefit obligation, however measured.**

9. Should a presentation of changes in the unfunded accrued benefit obligation be a required part of general purpose financial reporting? Why or why not?

- a. If yes, which financial report(s) should contain that presentation: the employer's, the plan's, or both? Why?**
- b. If yes, should the presentation be a basic financial statement, a note to the basic financial statements, or required supplementary information? Why?**