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Governmental Accounting Standards Series

# Preliminary Views

of the Governmental Accounting Standards Board

on major issues related to

# Pension Accounting and Financial Reporting by Employers

The GASB requests comments by September 17, 2010.

**Governmental Accounting Standards Board**
**of the Financial Accounting Foundation**

# PENSION ACCOUNTING AND FINANCIAL REPORTING BY EMPLOYERS

## Notice of Public Hearings and Request for Written Comments

### Public hearings:

October 13, 2010. The hearing will be held at the Hyatt Regency DFW Airport, 2334 N. International Parkway, DFW Airport, TX, beginning at 8:30 a.m. Central Time.

October 14, 2010. The hearing will be held at the offices of KPMG, 55 Second Street, Suite 1400, San Francisco, CA, beginning at 8:30 a.m. Pacific Time.

October 27, 2010. The hearing will be held at the Crowne Plaza LaGuardia, 104-04 Ditmars Blvd., East Elmhurst, NY, beginning at 8:30 a.m. Eastern Time.

### Deadline for written notice of intent to participate in the public hearings:

September 17, 2010

## PUBLIC HEARINGS

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

**Public hearing oral presentation requirements.** Individuals or organizations that want to make an oral presentation in person or by telephone at a public hearing are required to provide, **by the deadline for notice of intent to participate,** a written notification of that intent and a copy of written comments addressing the issues discussed in this Preliminary Views. 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 to the address below. The notification should indicate a preference for participating in person or via telephone. The public hearings 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 hearing.

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

## WRITTEN COMMENTS

**Deadline for submitting written comments:** September 17, 2010

**Requirements for written comments.** Any individual or organization that wants to provide written comments but does not intend to participate in the public hearings should provide those comments by **September 17, 2010.** Comments 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.

## OTHER INFORMATION

**Public files.** Written comments and transcripts of the public hearings will become part of the Board's public file and will be available for inspection at the Board's offices. Photocopies of those materials may be obtained for a specified charge. After the comment period, the comments will be posted on the GASB's website.

**Orders.** Any individual or organization may obtain one photocopy of this Preliminary Views on request without charge until September 17, 2010, by writing or phoning the GASB Order Department. For information on prices for additional copies and copies requested after that date, please contact the Order Department. The Preliminary Views also may be downloaded from the GASB's website at www.gasb.org.

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## Pension Accounting and Financial Reporting by Employers

June 16, 2010

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

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## Notice to Recipients

The Governmental Accounting Standards Board (GASB) is responsible for developing standards of state and local governmental accounting and financial reporting that will (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 Preliminary Views to solicit comments on the Board's proposals on major issues of pension accounting and financial reporting by employers.

This Preliminary Views is a step toward an Exposure Draft of a Statement of Governmental Accounting Standards but is *not* an Exposure Draft. A Preliminary Views is a Board document designed to set forth and seek comments on the Board's current views at a relatively early stage of a project. This document presents the Board's preliminary views on pension accounting and financial reporting by employers and discusses the concepts, purposes, and objectives related to the Board's proposal. A Preliminary Views generally is issued when the Board anticipates that respondents are likely to be sharply divided on the issues or when the Board itself is sharply divided on the issues. Because the Board anticipates that respondents likely will express a range of differing views on major issues related to the recognition and measurement of employers' pension liabilities and expenses, it believes that a Preliminary Views, rather than an Exposure Draft, is appropriate. Although some Board members may disagree with certain aspects of the Preliminary Views and some may feel more strongly about certain provisions than others do, this Preliminary Views represents the Board's current views on the issues discussed in this document.

We invite your comments on all matters in this Preliminary Views, especially those addressed in the questions on the following pages. Respondents are requested to give their views only after reading the entire text of this Preliminary Views and all of the questions. Because guidance proposed in this Preliminary Views may be modified before it is issued as an Exposure Draft, 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 responses to this Preliminary Views, it would be helpful if you explain the reasons for your views, including alternatives that you believe we should consider.

All responses are distributed to the Board and to staff members assigned to this project, and all comments are considered during deliberations leading to a final Statement. Only after the Board is satisfied that all alternatives have adequately been considered, and modifications, if any, have been made will a vote be taken to issue an Exposure Draft. The Board also will seek and consider comments on any future due process documents before proceeding to a final Statement.

# QUESTIONS FOR RESPONDENTS

## Issue 1—An Employer's Obligation to Its Employees for Defined Pension Benefits

1. It is the Board's preliminary view that, for accounting and financial reporting purposes, an employer is primarily responsible for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits. (See Chapter 2, paragraphs 5–10.) Do you agree with this view? Why or why not?

## Issue 2—Liability Recognition by a Sole or Agent Employer

2a. It is the Board's preliminary view that the unfunded portion of a sole or agent employer's pension obligation to its employees meets the definition of a liability (referred to as an employer's *net pension liability*). (See Chapter 3, paragraphs 1–8.) Do you agree with this view? Why or why not?

2b. It is the Board's preliminary view that the net pension liability is measurable with sufficient reliability to be recognized in the employer's basic financial statements. (See Chapter 3, paragraphs 9–13.) Do you agree with this view? Why or why not?

## Issue 3—Measurement of the Total Pension Liability Component of the Net Pension Liability by a Sole or Agent Employer

3a. It is the Board's preliminary view that the projection of pension benefit payments for purposes of calculating the total pension liability and the service-cost component of pension expense should include the projected effects of the following when relevant to the amounts of benefit payments: (1) automatic cost-of-living adjustments (COLAs), (2) future ad hoc COLAs in circumstances in which such COLAs are not substantively different from automatic COLAs (see also question 3b), (3) future salary increases, and (4) future service credits. (See Chapter 4, paragraphs 4–13.) Do you agree with this view? Why or why not?

3b. What criteria, if any, do you suggest as a potential basis for determining whether ad hoc COLAs are not substantively different from an automatic COLA and, accordingly, should be included in the projection of pension benefit payments for accounting purposes?

3c. It is the Board's preliminary view that the discount rate for accounting and financial reporting purposes should be a single rate that produces a present value of total projected benefit payments equivalent to that obtained by discounting projected benefit payments using (1) the long-term expected rate of return on plan investments to the extent that current and expected future plan net assets available for pension benefits are projected to be sufficient to make benefit payments and (2) a high-quality municipal bond index rate for those payments that are projected to be made beyond the point at which plan net assets available for pension benefits are projected to be fully depleted. (See Chapter 4, paragraphs 14–23.) Do you agree with this view? Why or why not?

3d. It is the Board's preliminary view that for purposes of determining the total pension liability of a sole or agent employer, as well as the service-cost component of pension expense, the present value of projected benefit payments should be attributed to financial reporting periods over each employee's projected service life using a single method—the entry age actuarial cost method applied on a level-percentage-of-payroll basis. (See Chapter 4, paragraphs 24–34, and Chapter 5, paragraphs 6 and 7.) Do you agree with this view? Why or why not?

## Issue 4—Attribution of Changes in the Net Pension Liability to Financial Reporting Periods by a Sole or Agent Employer

4a. It is the Board's preliminary view that the effects on the net pension liability of changes in the total pension liability resulting from (1) differences between expected and actual experience with regard to economic and demographic factors affecting measurement, (2) changes of assumptions regarding the future behavior of those factors, and (3) changes of plan terms affecting measurement should be recognized as components of pension expense over weighted-average periods representative of the expected remaining service lives of individual employees, considering separately (a) the aggregate effect on the liabilities of active employees to which the change applies and (b) the aggregate effect on the liabilities of inactive employees. (See Chapter 5, paragraphs 8–10.) Do you agree with this view? Why or why not?

4b. It is the Board's preliminary view that the effects on the net pension liability of projected earnings on plan investments, calculated using the long-term expected rate of return, should be included in the determination of pension expense in the period in which the earnings are projected to occur. Earnings on plan investments below or above the projected earnings should be reported as deferred outflows (inflows) unless cumulative net deferred outflows (inflows) resulting from such differences are more than 15 percent of the fair value of plan investments, in which case the amount of cumulative deferred outflows (inflows) that is greater than 15 percent of plan investments should be recognized as an increase or decrease in expense immediately. (See Chapter 5, paragraphs 12–15.) Do you agree with this view? Why or why not?

## Issue 5—Recognition by a Cost-Sharing Employer

5a. It is the Board's preliminary view that each employer in a cost-sharing plan is implicitly primarily responsible for (and should recognize as its net pension liability) its proportionate share of the collective unfunded pension obligation, as well as its proportionate share of the effects of changes in the collective unfunded pension obligation. (See Chapter 6.) Do you agree with this view? Why or why not?

5b. The Board is considering basing the determination of proportionate shares of the collective net pension obligation on employers' respective shares of the total annual contractually required contributions to the plan and believes that would provide a reliable basis for measurement. However, the Board is seeking constituent input regarding other

potential bases that might exist for this determination. (See Chapter 6, paragraph 8.) What basis, if any, do you suggest for determining a cost-sharing employer's proportionate share of the collective net pension obligation?

## Issue 6—Frequency and Timing of Measurements

6. The Board's preliminary view is that a comprehensive measurement (an actuarial valuation for accounting and financial reporting purposes) should be made at least biennially, as of a date not more than 24 months prior to an employer's fiscal year-end. If the comprehensive measurement is not made as of the employer's fiscal year-end, the most recent comprehensive measurement should be updated to that date. Professional judgment should be applied to determine the procedures necessary to reflect the effects of significant changes from the most recent comprehensive measurement date to the employer's fiscal year-end. Determination of the procedures needed in the particular facts and circumstances should include consideration of whether a new comprehensive measurement should be made. (See Chapter 7.) Do you agree with this view? Why or why not?

# Summary

This Preliminary Views presents the Board's current views on what it believes are the most fundamental issues related to employer accounting and financial reporting for pensions in order to obtain comments from constituents before developing more detailed proposals for changes to existing standards. The views put forth in the document generally are discussed as principles or concepts rather than as detailed potential requirements. Additional details of the application of the concepts described in this Preliminary Views will be discussed further by the Board in future deliberations of project issues. Most of the issues on which preliminary views of the Board are presented previously were discussed in Chapters 2–6 of the GASB's March 2009 Invitation to Comment, *Pension Accounting and Financial Reporting*. This Preliminary Views also addresses issues related to the timing and frequency of measurements for accounting and financial reporting purposes.

## Origins of Pension Benefits and Relationships among Parties

Underlying these preliminary views is a reaffirmation by the Board of a conclusion previously expressed in earlier standards related to pension benefits: Defined pension benefits are a component of an exchange transaction between an employer and its employees of salaries and benefits for employees' services.

In the view of the Board, for accounting and financial reporting purposes, an employer has an obligation to its employees for pension benefits by virtue of the employment exchange, and this obligation is not satisfied until the defined benefits have been paid to the employees or their beneficiaries. In the Board's view, an employer remains primarily responsible for the portion of its benefit obligation to employees in excess of the plan net assets available for pension benefits that have been accumulated in a pension plan (trust). To the extent that plan net assets have been accumulated, the employer becomes secondarily responsible, and the pension plan is primarily responsible for the obligation.

## Sole and Agent Employers

### Recognition of a Liability

It is the Board's preliminary view that the unfunded pension obligation to employees, for which a sole or agent employer is primarily responsible for financial reporting purposes, meets the definition of a liability. Further, it is the Board's preliminary view that the unfunded pension obligation (hereinafter referred to as the *net pension liability*) of a sole or agent employer is measurable with sufficient reliability for recognition in an employer's basic financial statements.

### Measurement

The net pension liability of a sole or agent employer is calculated as the difference between two components: (1) the employer's total pension liability to its employees by virtue of the employment exchanges through the end of the financial reporting period and

(2) an amount equal to the plan assets, net of other plan liabilities, that are available for payment of pension benefits as of the end of the employer's financial reporting period.

Measurement of the employer's total pension liability involves projecting benefit payments, discounting projected benefit payments to a present value, and attributing the present value of projected benefit payments to periods.

### *Projection of Benefit Payments*

For financial reporting purposes, it is the Board's preliminary view that the projection of benefit payments would include the projected effects of each of the following types of future changes:

- Automatic cost-of-living adjustments (COLAs)
- Projected future ad hoc COLAs, referring in this context to COLAs that are dependent upon a decision to grant by a responsible authority, when relevant facts and circumstances indicate that such COLAs are not substantively different from automatic COLAs
- Projected future salary increases in circumstances in which the pension benefit formula is based on future compensation levels
- Projected future service credits both in determining an employee's probable eligibility for benefits and in projecting benefit payments in circumstances in which the pension benefit formula is based on years of service.

### *Discount Rate*

The Board believes that the total pension liability can be viewed as derived from two benefit payment streams with different measurement implications. These two streams are (1) benefit payments to employees currently in the plan that are projected to be paid from plan net assets held in trust and available for pension benefits, adjusted for relevant projected increases and decreases, and (2) benefit payments to those employees that are expected to occur beyond the point at which plan net assets available for pension benefits are projected to be fully depleted. Therefore, the preliminary view of the Board is that the discount rate for accounting and financial reporting purposes would be a single rate that produces a present value of total projected benefit payments equivalent to that obtained by discounting projected benefit payments using:

- The long-term expected rate of return on plan net assets to the extent that current and expected future pension plan net assets available for pension benefits are projected to be sufficient to provide for payment of benefits in future periods
- A high-quality municipal bond index rate for those payments that are projected to be made beyond the point at which plan net assets available for pension benefits are projected to be fully depleted.

### *Attribution of the Present Value of Projected Benefit Payments to Periods*

It is the preliminary view of the Board that for purposes of determining the total pension liability of a sole or agent employer, as well as determining the service-cost component of pension expense (discussed below), the present value of projected benefit payments for an employee would be attributed to that employee's expected periods of service as a level percentage of payroll using the method described in the current standards as the entry age actuarial cost method.

## Pension Expense and Deferred Pension Outflows (Inflows)

Changes in an employer's net pension liability from period to period can occur as the result of several types of transactions or other events, including:

- Employee services during the period
- Interest on the beginning total pension liability
- Differences between expected and actual experience with regard to economic and demographic factors affecting measurement of the total pension liability
- Changes of assumptions regarding the expected future behavior of economic and demographic factors affecting measurement of the total pension liability
- Changes of plan terms that affect the amount of pension benefits associated with employee services in past periods
- Changes in plan net assets available for pension benefits.

The Board's preliminary view is that the amount of projected pension benefits attributed to a period of employee service (service cost) and interest on the beginning total pension liability would be recognized as pension expense in that period. Other changes in the total pension liability would be recognized as deferred pension outflows (inflows) in the period of the change and recognized as pension expense over periods representative of the expected remaining service lives of individual employees, considering separately (1) the aggregate effect on the liabilities for active employees to which the change applies and (2) the aggregate effect on the liabilities for inactive employees. To the extent that such changes relate to past periods of service of active plan employees, the amortization period would be an average expected remaining service life with weighting to approximate the result that would be obtained if such changes were amortized individually for each active employee. Current-period changes related to past periods of service of inactive (including retired) employees would be recognized as expense immediately in the period of the change.

Expected earnings on plan investments, calculated using the expected long-term rate of return, would be included in the determination of pension expense in the period in which the earnings are projected to occur. Earnings on plan investments that differ from the expected earnings for a period would be reported as deferred outflows (inflows) unless cumulative net deferred outflows (inflows) resulting from such differences are more than 15 percent of the fair value of plan investments. If cumulative net deferred outflows (inflows) are more than 15 percent of the fair value of plan investments at the end of a financial reporting period, the amount of cumulative net deferred outflows (inflows) that

is greater than 15 percent of the fair value of plan investments would be recognized immediately as an addition to (reduction of) pension expense.

Changes in plan net assets available for pension benefits that are not associated with investments would be recognized immediately as additions to (reductions of) pension expense.

## Cost-Sharing Employers

In the view of the Board, each employer in a cost-sharing plan is primarily responsible for a part of the collective net pension liability representing its implicit proportionate share of the shared benefit risks and pooled plan assets. The Board's preliminary view is that a cost-sharing employer would recognize as its net pension liability, pension expense, and deferred pension outflows (inflows) its proportionate share of the collective net pension liability, pension expense, and deferred pension outflows (inflows). For this purpose, the collective net pension liability, pension expense, and deferred pension expense would be calculated using the same measurement and attribution approaches that are discussed above for application to measurements for sole and agent employers.

## Frequency and Timing of Pension Measurements

It is the Board's preliminary view that an employer would report its net pension liability measured as of its fiscal year-end. Plan net assets available for pension benefits would reflect their values at the employer's fiscal year-end. Measurement of the employer's total pension liability would be as follows:

- A comprehensive measurement (an actuarial valuation for accounting and financial reporting purposes) of the total pension liability would be required at least every other year (biennially).
- A comprehensive measurement of the total pension liability would not be required to be as of an employer's fiscal year-end; however, the comprehensive measurement used as the basis for determining an employer's net pension liability reported at its fiscal year-end would need to be as of a date no more than 24 months prior to the employer's fiscal year-end.
- If a comprehensive measurement of the total pension liability is not made as of the employer's fiscal year-end, the most recent comprehensive measurement would need to be updated to that date. Updated measures would be required to reflect the effects of all significant changes since the most recent comprehensive-measurement date. Professional judgment would need to be applied to determine the procedures required to reflect the effects of such changes. Determination of the procedures appropriate in the particular circumstances would include consideration of whether a new comprehensive measurement was needed.

## How the Changes Proposed in This Preliminary Views Would Improve Financial Reporting

The information that would be required by the Board's proposals in this Preliminary Views, if ultimately issued as a Statement, would enhance public officials' accountability for pension obligations and provide decision-useful information by requiring recognition of the effects of pertinent transactions and other events on the net pension liability reported by the employer in the period in which they occur. By improving the measurement of pension expense, the proposed changes also would provide information that would better assist financial report users in assessing the relationship between current-year revenues and the cost of the services provided by the government that year. If adopted, these proposals also would enhance the consistency and the comparability of reported information and reduce complexity for users of financial reports by reducing unnecessary measurement alternatives.

The Board notes that the changes proposed in this Preliminary Views are only a part of the total accounting and financial reporting "package" that ultimately might be required. The Board plans to deliberate other issues, including issues pertaining to note disclosures and required supplementary information, following the issuance of this Preliminary Views.

# CHAPTER 1—OBJECTIVES AND BACKGROUND

## Objectives of the Postemployment Benefit Accounting and Financial Reporting Project

1. In its postemployment benefit accounting and financial reporting project, the Board is considering changes to current standards of accounting and financial reporting for pension benefits and other postemployment benefits (OPEB) by state and local governmental employers and by the trustees, administrators, or sponsors of pension or OPEB plans. One of the principal objectives of this project is to improve accountability for the effects of pension and OPEB transactions and other events on elements of the basic financial statements of employers and plans. A part of that objective is to develop standards that will result in the financial reporting of information that will help users of financial reports assess the relationship between a government's inflows of resources and its total cost (including pension expense) of providing government services each period. The other principal objective of this project is to improve the usefulness of information for decisions or judgments of relevance to the various users of the general purpose external financial reports of governmental employers and pension or OPEB plans.

2. The project ultimately is expected to result in a Statement or Statements of Governmental Accounting and Financial Reporting Standards pertaining to accounting and financial reporting for pension benefits and OPEB by employers and plans. However, the scope of Board discussion on the project to date has been limited to what the Board believes to be the most fundamental issues related to recognition and measurement of pensions by employers. Other project issues, potentially including pension-plan financial reporting issues, employer and plan disclosure issues, issues related to OPEB accounting and financial reporting by employers, and OPEB-plan financial reporting issues, will be discussed by the Board and will be subject to additional due process following the issuance of this Preliminary Views.

## Project Background

3. Current pension accounting and financial reporting standards for employers were established in Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers,* which was issued in November 1994 and was effective for financial reporting periods beginning after June 15, 1997, with early implementation encouraged and chosen by some employers. Several subsequent Statements have updated or otherwise amended specific provisions of Statement 27. Also, the GASB subsequently considered accounting and financial reporting issues similar to those for pensions during the development of Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* which was issued in June 2004. The approach taken in Statement 45 was to model OPEB accounting and financial reporting by employers on Statement 27, with adaptations only as essential to accommodate pension/OPEB differences, in order to create a consistent overall approach applicable to all postemployment benefits. Accordingly, the employer pension accounting and financial

reporting approach originally established in Statement 27 has continued in effect with no fundamental change to date.

4. Subsequent to the issuance of Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* and Statement 27, significant work was completed on the development of the GASB's conceptual framework. The issuance of Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports That Contain Basic Financial Statements,* in April 2005, and of Concepts Statement No. 4, *Elements of Financial Statements,* in June 2007, were of particular significance for consideration of pension accounting and financial reporting issues. Concepts Statement 3 established criteria for selection of the appropriate method of communication—recognition in basic financial statements, note disclosure, or presentation as required supplementary information or supplementary information—for items of reportable financial information. Concepts Statement 4 established conceptual definitions and characteristics of elements of financial statements, including, most notably for pensions, *liabilities, outflows of resources, deferred outflows of resources,* and *deferred inflows of resources.*

5. Consistent with the GASB's commitment to periodically reexamine its standards, in January 2006 the Board approved a research project to gather information regarding how effective Statements 25 and 27 had been in meeting financial reporting objectives. A research report that encompassed the research efforts and findings was prepared and presented to the Board in April 2008.

6. In light of the issues identified in the research project and the conceptual developments that had occurred since the issuance of Statements 25 and 27, the postemployment benefit accounting and financial reporting project was added to the GASB's current technical agenda in April 2008. At that time, work began on the development of the project's initial public comment document—the Invitation to Comment, *Pension Accounting and Financial Reporting*—which was issued in March 2009.

7. The Invitation to Comment was a staff document that sought constituent views on issues and questions related to (a) the focus of accounting and financial reporting for pensions; (b) sole- and agent-employer pension expense and liability recognition and measurement, including the use of actuarial methods; and (c) accounting by employers in cost-sharing plans. In addition, the Invitation to Comment presented issues and questions specific to financial reporting by pension plans. The Board received 118 written responses to the Invitation to Comment from organizations and individuals. In addition, the Board received oral responses from, and had the opportunity to further explore the views of, 17 individuals or groups at two public hearings in Norwalk, CT and Washington, DC.

8. From October 2009 through June 2010, the Board discussed and reached tentative conclusions on the basic employer accounting and financial reporting issues presented for public comment in the Invitation to Comment. Discussions included consideration of the views and suggestions expressed by respondents to the Invitation to Comment, as well as comments received from members of the project task force—comprising 18 experts

broadly representative of the GASB's constituency—at a meeting of that group in December 2009 and throughout the development of this document. In addition, the Board regularly has updated the members of the Governmental Accounting Standards Advisory Council (GASAC) on project developments and has heard feedback from GASAC members as part of that organization's periodic meetings. The tentative conclusions reached by the Board on basic employer accounting and financial reporting issues through this process form the preliminary views included in this document.

## Objective of This Preliminary Views

9. The objective of this Preliminary Views is to present the Board's current views on what it believes are the most fundamental issues related to employer recognition and measurement of pensions in order to obtain comments from constituents before developing more detailed proposals for changes to existing standards. The views put forth in the chapters that follow generally are discussed as principles or concepts rather than as detailed potential requirements. Additional details of the application of the concepts described in this document will be discussed further by the Board in future deliberations of project issues. Most of the issues on which preliminary views of the Board are presented previously were discussed in Chapters 2–6 of the Invitation to Comment. This Preliminary Views also addresses issues related to the timing and frequency of measurements for accounting and financial reporting purposes. The Board believes that the issues presented in this document are issues on which the views of those with an interest in the subject are most likely to differ sharply.

10. In addition to presenting the Board's preliminary views, this document includes discussion of the concepts and objectives underlying the Board's tentative proposals. The Board's deliberations are informed, first, by considerations identified in the GASB's Concepts Statements, including those related to the following:

- Objectives of financial reporting—accountability, decision usefulness, and interperiod equity (Concepts Statement No. 1, *Objectives of Financial Reporting,* and Concepts Statement 4)
- The various users and uses of information regarding pensions in general purpose external financial reporting (Concepts Statement 1)
- The definitions of the elements of financial statements, including liabilities, outflows of resources, and deferred outflows (inflows) of resources (Concepts Statement 4)
- The selection of appropriate methods of communicating information in general purpose external financial reports that contain basic financial statements (Concepts Statement 3).

11. Building on the GASB's conceptual framework, the Board's deliberations on issues discussed in this Preliminary Views also were guided and informed by several general principles or considerations, which are summarized in the paragraphs below and are discussed more specifically in relation to each of the Board's preliminary views in the chapters that follow.

## Financial Reporting Focus

12. As noted above, the objective of this project is to establish standards of accounting and financial reporting for postemployment benefits. It is not within the scope of the Board's activities to establish standards with regard to a government's method of financing the benefits it has obligated itself to provide (that being a policy decision for government officials or other responsible authority to make) or to regulate a government's compliance with the financing policy or method it adopts. Accordingly, the proposals put forth in this Preliminary Views are made solely within the context of accounting and financial reporting, not within the context of the funding of pension benefits.

13. Similarly, the Board has heard and considered views from proponents of two distinctly different approaches to the measurement of pension obligations and expense by employers—a financial-economics (fair-value) approach and an actuarial-funding (asset-accumulation) approach. However, it is important to note that the Board has approached the issues in the context of its own financial reporting objectives, concepts, and evolving standards, with consideration of the nature of the transactions and other events being reported and the environment in which those events occur and are reported.

14. Accordingly, the Board's deliberations of the fundamental employer accounting and financial reporting issues addressed in this Preliminary Views primarily have focused on:

- Analysis of the transactions and other events through which an employer incurs an obligation to provide pension benefits and analysis of how the obligation subsequently is modified and ultimately is satisfied
- Consideration of the effects of those transactions and other events on the elements of an employer's financial statements (assets, liabilities, net assets, inflows or outflows of resources, and deferred inflows or outflows of resources) defined in Concepts Statement 4
- Issues related to the financial reporting period or periods to which those effects should be attributed and how they should be measured for accounting and financial reporting purposes in the governmental environment.

## Long-Term Nature of Governments

15. One of the distinguishing characteristics of state and local governments is their potential for longevity. As discussed in the GASB's White Paper, *Why Governmental Accounting and Financial Reporting Is—and Should Be—Different,* one of the effects of the longevity of governments on accounting and financial reporting is that accounting information is used not to answer questions about whether governments will continue to exist but rather for insight into "the sustainability of the level of services provided and the ability to meet future levels of demand for services. As a result, the emphasis generally has been on the allocation of resources to government programs, the determination of the cost of services . . . , and providing a longer term view of operations. The longer term view of operations of government is consistent with focusing on trends in operations, rather than on short-term fluctuations . . ." (page 8). Cost-of-services information also is essential to the objectives of financial reporting discussed in Concepts Statement 1, including that of

helping financial report users assess the degree to which *interperiod equity*—a term used in Concepts Statements 1 and 4 to describe the state in which current-period inflows of resources equal current-period costs of services—has been achieved. The Board's deliberation of issues related to employer accounting and financial reporting for pensions, particularly questions related to measurement of liabilities (discussed in Chapters 4 and 6) and recognition of pension expense (discussed in Chapters 5 and 6), reflects consideration of the long-term, ongoing nature of governments and the importance of information about the cost of services to users of governmental employer financial statements.

### The Employer–Employee Exchange

16. The Board's preliminary views presented in this document also build on consideration of the implications of a previously established conclusion, most fully expressed in Statement 45, that pension benefits arise from an exchange between an employer and employees of salaries and benefits for employee services each period (discussed in Chapter 2). The most prominent implication (discussed in Chapter 3) is that an employer incurs an obligation to its employees for pension benefits as a result of the employment-exchange transactions. The Board's perspective that these transactions should be viewed in the context of an ongoing, career-long employment relationship has implications related to the measurement of the employer's pension liability (discussed in Chapter 4) and related to recognition of pension expense (discussed in Chapter 5).

## Effects of the Board's Preliminary Views on Current Standards

17. The preliminary views presented in this document, with further development or modification in subsequent due process documents, potentially will modify current standards set forth in Statement 27, as amended. However, this document discusses the Board's preliminary views at a level of broad principles, and descriptions of how those views would supersede or amend specific paragraphs of existing, authoritative standards would be premature at this stage of the project. Therefore, specific proposed amendments of existing standards are not presented in this document; however, those proposed amendments will be included in the next due process document—an Exposure Draft.

# CHAPTER 2—AN EMPLOYER'S OBLIGATION TO ITS EMPLOYEES FOR DEFINED PENSION BENEFITS

## An Obligation to Employees for Defined Pension Benefits Is Created by the Employment Exchange

1. Underlying these preliminary views is a reaffirmation by the Board of a conclusion previously expressed in Statements 27 and 45 about the origin and substance of pension benefits. That is, pension benefits are a component of exchange transactions between an employer and its employees of salaries and benefits for employees' services. They are provided to employees—on a deferred-payment basis—as part of the total compensation package offered by employers for employee services each financial reporting period.

2. In the development of Statement 27, the Board discussed its belief that pension benefits arise from an employment exchange in paragraphs 18 and 19 of the 1990 Exposure Draft on employer accounting and reporting for pension benefits. In the context of discussing accrual-basis accounting, the Board noted that:

> The provision of services by an entity's employees in exchange for the right to receive compensation is a transaction that affects the entity's resources and should be recognized in each accounting period when the exchange occurs, regardless of when compensation is paid.
>
> Pension benefits are part of the total compensation earned by employees for their services. . . .

Similarly, in paragraph 68 of the Basis for Conclusions of Statement 27, the Board explained its approach to establishing requirements related to determining annual pension cost—the measure of expense required to be recognized in that standard—in periods "when employee service giving rise to the benefits is performed."

3. Even though the employer and employees have agreed that a portion of the total compensation for those services, in the form of pension benefits, will be paid later (in retirement), the employer receives full value from the employment exchange each period in the form of employee services. Therefore, **the Board's preliminary view in this project is that as a result of the employment exchange each year, the employer incurs an obligation to its employees for pension benefits.** Paragraph 18 of Concepts Statement 4 defines an *obligation* 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." The obligation of a state or local governmental employer to its employees for pension benefits generally is a legal (statutory or contractual) obligation to pay defined benefits to employees or their beneficiaries in retirement.

4. Between the initial creation of the obligation through the employment exchange and the payment of the benefits to employees or their beneficiaries in retirement, additional transactions and other events affecting the benefit obligation occur. Examples of transactions and other events that may create or modify the initial obligation include changes in the factors of the defined benefit formula (such as salary increases and the

attainment by employees of additional service credits), retroactively applied benefit increases, and the incurrence of interest on previous balances due to the passage of time. Also, because measurement of the pension obligation necessarily involves projections that incorporate assumptions about the future, differences between expected and actual outcomes with regard to economic and demographic factors will affect the measurement of the obligation.

## An Employer Remains Primarily Responsible for the Unfunded Portion of the Pension Obligation

5. In addition to the employer–employee relationships from which an employer's obligation to its employees for pension benefits arises, an employer typically creates or agrees to the creation of a legally separate entity—the pension plan—to administer in trust the accumulation of plan net assets that are dedicated for pension benefits and the payment of the defined benefits to retired employees or their beneficiaries when due. An employer's relationship with the pension plan is characterized by the adoption of a program of (actual or presumed) systematic annual employer contributions to the plan in amounts projected to be sufficient, when added to employee contributions (if any) and expected earnings on the investment of plan assets, to provide for payment of the defined pension benefits. A third relationship typically also exists between the pension plan and employees or their beneficiaries characterized by employee contributions to the plan prior to retirement and, afterward, the payment by the plan of benefits earned by the employees through their services to the employer.

6. After considering a number of alternative methods of modeling the substance of these relationships, **the Board's preliminary view is that for accounting and financial reporting purposes, an employer has an obligation to its employees for pension benefits by virtue of the employment exchange, and this obligation is not satisfied until the defined pension benefits have been paid to the employees or their beneficiaries when due. In the Board's view, an employer remains primarily responsible for the portion of its benefit obligation to employees in excess of the plan net assets available for pension benefits. To the extent that plan net assets have been accumulated, the employer becomes secondarily responsible, and the pension plan is primarily responsible, for the obligation.**

7. This view of primary and secondary responsibility has important implications for accounting and financial reporting purposes:

- The portion of the obligation to employees for pension benefits for which the employer is primarily responsible is reduced as, and to the extent that, dedicated assets are accumulated in the pension plan.
- The plan is primarily responsible for the obligation only to the extent that it has plan net assets available to satisfy the obligation. It cannot be primarily responsible for the obligation beyond the limits of the plan net assets that it has at its disposal for that purpose.
- The employer is secondarily responsible for the funded portion of the benefit obligation to employees, as well as primarily responsible for the unfunded portion of

the obligation. This recognizes that ultimately it is the employer that has the obligation to employees to provide pension benefits by virtue of the employment exchange. If, for example, currently existing plan net assets were to be reduced in the future (for example, as the result of investment losses), the employer's obligation still would remain. Moreover, other things being equal, the unfunded portion of that obligation (for which the employer is primarily responsible) would increase. On the other hand, other things being equal, as plan net assets increase, the unfunded portion of the obligation decreases.

8. In reaching its preliminary views on this issue, the Board considered and rejected several other views. One of the views considered was that the employer's responsibility for the obligation to its employees for pension benefits is fully discharged by the creation of a pension plan. Under this view, the pension plan is considered to have assumed fully the employer's original obligation to employees for benefits irrespective of the status of the accumulation of plan net assets, and the employer's obligation, if any, is considered to be limited to making contributions to the plan pursuant to the funding policy adopted. However, the Board is not persuaded that the existence of a pension plan, combined with the adoption of a funding plan and the achievement of some degree of funding progress, is sufficient to settle the employer's obligation to its employees as a result of the original employment-exchange transactions. Further, the Board does not believe that the pension plan appropriately can be viewed as assuming the portion of the pension obligation that exceeds the amount of plan net assets available for pension benefits.

9. The Board also considered the view that the employer is responsible for the entire obligation to provide pension benefits to employees, without reduction for the amount of net assets held in trust for pension benefits by the pension plan, which is an entity legally separated from the employer. However, the Board believes that this view does not appropriately consider the relationship that exists between the employer and the pension plan with regard to the accumulation of plan net assets dedicated to the payment of pension benefits.

10. With regard to these alternatives, the Board believes that the concept of primary and secondary responsibility for portions of the employer's obligation to its employees for pension benefits provides a basis for a more faithful representation of the financial effects of both (a) the annual exchanges between employer and employees and (b) the accumulation of dedicated plan net assets in the pension plan, for accounting and financial reporting purposes.

# CHAPTER 3—LIABILITY RECOGNITION BY A SOLE OR AGENT EMPLOYER

## The Unfunded Obligation to Employees Meets the Definition of an Employer Liability

1. Under the current pension recognition approach for sole and agent employers established in Statement 27, as amended, expense recognition is based on a systematic and rational funding program, and a liability is recognized in the amount of the cumulative difference, if any, between actual contributions and amounts recognized as expense to date. This approach was developed prior to the issuance of:

- Concepts regarding definitions of elements of financial statements, including liabilities, outflows of resources, and deferred outflows (inflows) of resources (in Concepts Statement 4)
- Concepts regarding methods of communication of information in reports that contain basic financial statements (in Concepts Statement 3).

2. These concepts have provided a more fully developed context for consideration of issues related to pension liability recognition by sole and agent employers. Concepts Statement 4, paragraph 17, defines *liabilities,* thereby establishing a basis for considering whether the unfunded pension obligation to employees created by the employment exchange is a liability. Concepts Statement 3 establishes an additional criterion for recognition of an item that meets the definition of an element in basic financial statements. That is, in order to be recognized, an item should be both an element of financial statements *and* measurable with sufficient reliability for that purpose. For such items, note disclosure may be used to provide additional details. However, Concepts Statement 3, paragraph 34, provides that neither note disclosure nor presentation as required supplementary information or supplementary information is "an adequate substitute for recognition in the financial statements."

3. Concepts Statement 4, paragraph 17, defines the financial statement element *liabilities* as "present obligations to sacrifice resources that the government has little or no discretion to avoid." **It is the Board's preliminary view that the unfunded pension obligation to employees, for which a sole or agent employer is primarily responsible for financial reporting purposes, meets the definition of a liability.** This encompasses the Board's views that (a) an employer has an obligation to sacrifice resources in order to provide defined pension benefits to its employees or their beneficiaries in retirement, (b) the obligation is a present obligation, and (c) the employer has little or no discretion to avoid a sacrifice of its resources to fulfill the obligation.

4. In Concepts Statement 4, paragraph 18, 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." The Board believes that an employer's obligation to sacrifice resources to provide defined pension benefits to its employees or their beneficiaries in retirement is supported, constructively, by the conclusion that pension

benefits are a part of an exchange of salaries and benefits for employee services and also legally, in many cases, by formalization of the plan terms, including vesting provisions, in state constitutions, statutes, ordinances, or contracts.

5. Further, the Board believes that an employer's obligation to provide pension benefits associated with employee services to date is a *present obligation* because that obligation was created as a consequence of employment exchanges that already have occurred. When pension benefits are part of an employee's total compensation, payments of the benefits in fulfillment of that obligation are not due until future periods; however, in accrual accounting, the obligation to make those payments is a present obligation created by past transactions.

6. Concepts Statement 4, paragraph 20, notes that a government has "little or no discretion to avoid the sacrifice of resources" when 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. Many obligations cannot be avoided because they are legally enforceable—that is, a court could compel the government to fulfill its obligation because of constitutional or statutory provisions, often enacted by a higher level of government, or contractual relationships. For exchange transactions as a category, an obligation becomes a liability when the underlying exchange takes place. Although legally enforceable rights may apply to pension obligations prior to vesting in some jurisdictions, the Board believes that it is clear that pension obligations are legally enforceable with regard to individual employees when vesting provisions have been met.

7. In addition, Concepts Statement 4, paragraph 19, makes clear that the basis for an obligation to sacrifice resources can vary depending on circumstances. In some circumstances, a constructive liability is created "not because it is legally enforceable but because of a government's actions or conduct" and the reliance of others, in which case "social, moral, or economic consequences leave the government little or no discretion to avoid the sacrifice of resources." Constructive liabilities generally arise from exchange transactions. One such transaction would be services provided by employees. Once services are rendered, the employer has an obligation to fulfill its part of the agreement. A government's obligation to its employees to provide postemployment benefits is an example provided in paragraph 19 of Concepts Statement 4 of a potential liability that may exist for social, moral, or economic reasons, even if such compensation is not legally enforceable.

8. Applying the preceding concepts, the Board believes that, whether legally or constructively, a sole or agent employer has little or no discretion to avoid the sacrifices of resources necessary to provide the assets needed to satisfy its obligation to its employees for defined pension benefits arising from exchanges of salaries and benefits for employee services. The Board notes that the accumulation of substantial assets in trust to partially secure payment, governments' track records in making the promised payments when due, and their inability or reluctance to retroactively reduce pension benefits already earned by past services, even in fiscally difficult circumstances, support the view that the employer

lacks discretion in avoiding the sacrifice of resources necessary to fulfill its pension obligations.

## The Employer's Unfunded Pension Liability Is Measurable with Sufficient Reliability for Recognition in Basic Financial Statements

9. The Board also has considered the question of whether the unfunded pension liability—hereinafter referred to as the *net pension liability*—of a sole or agent employer is measurable with sufficient reliability for recognition in an employer's basic financial statements. As discussed previously, Concepts Statement 3 states that to qualify for recognition in basic financial statements, an item of information that is an element of basic financial statements also should be measurable with sufficient reliability for that purpose. **It is the Board's preliminary view that the net pension liability is measurable with sufficient reliability for recognition.**

10. Concepts Statement 1 provides context regarding the Board's understanding of the qualitative characteristic of reliability. In paragraph 64 of that Concepts Statement, the GASB identified reliability as a characteristic of information presented in financial reports that is necessary for those reports to communicate effectively. Reliable information is free from bias, faithfully represents what it purports to represent, is comprehensive, and is not misleading. However, it is important to note that reliability "does not imply precision or certainty." Sometimes there may necessarily be a degree of estimation involved in measurement, as well as inherent uncertainties in what is measured. Because these conditions affect reliability, disclosures of assumptions used in the measurement process and inherent uncertainties may be needed. Nevertheless, "under certain circumstances some financial information is based on reasonable estimates" and "a properly explained estimate provides more meaningful information than no estimate at all."

11. The measurement of an employer's net pension liability is subject to inherent uncertainty with regard to demographic and economic factors on which the amounts to be paid depend. Measurement, therefore, requires the use of assumptions (estimates) about future events. As suggested by the discussion of reliability in Concepts Statement 1, neither of these conditions is unique or has necessarily proven to be a barrier to reliable financial reporting. The Board notes that uncertainties with regard to amounts expected to be received or paid in the future have been incorporated into the measurement of elements of basic financial statements in other contexts. For example, the fair values of investments, especially formula-based estimates, impound uncertainty about future payments; depreciation requires estimates of useful lives; and solid waste closure costs and pollution remediation obligations require estimates of uncertain future amounts.

12. With regard to defined benefit pensions, the Board notes that uncertainty regarding measurement of the net pension liability relates primarily to the amounts of future benefit payments. The uncertainty generally is not about whether a present obligation exists or whether it is likely that resources will be required to be sacrificed to pay earned pension benefits when due. This suggests that recognition of an estimate of an employer's net pension liability that requires assumptions and application of judgment, provided those assumptions and judgments are disclosed, would be significantly more reliable than no

recognition of that liability at all. Moreover, the Board notes that the types of estimation methods that would be required to measure the net pension liability are well developed and have been relied upon for many years both for funding and for financial reporting purposes.

13. As previously discussed, Concepts Statement 3 states that when an item of information both is an element of financial statements and is measurable with sufficient reliability, disclosure of that information or presentation of the information as required supplementary information or supplementary information would not be an adequate substitute for recognition in basic financial statements. Because the Board believes that the net pension liability meets both criteria, that liability should be recognized in the basic financial statements of a sole or agent employer.

## The Statement 27 Net Pension Obligation

14. The Board considered but rejected carrying forward the requirement of Statement 27 that a sole or agent employer should recognize as its pension liability the *net pension obligation* (NPO), representing the cumulative difference between (a) an employer's annual pension cost, derived from the *annual required contribution of the employer* (the ARC), and (b) the amounts the employer actually has contributed to the pension plan in relation to the ARC to date. The ARC and NPO-based approach implies that the employer's liability to its employees for pension benefits has been transferred to the plan and that annual funding requirements have been substituted for the original liability. Such a recognition approach is inconsistent with the Board's view that the employer retains primary responsibility for its liability to its employees to the extent that dedicated plan net assets have not been accumulated in a plan to satisfy it, as well as secondary responsibility for the funded portion of the liability, until defined benefits have been paid.

# CHAPTER 4—MEASUREMENT OF THE NET PENSION LIABILITY BY A SOLE OR AGENT EMPLOYER

1. The net pension liability of a sole or agent employer is calculated as the difference between its two components:

- The employer's total pension liability to its employees by virtue of employment exchanges through the end of the financial reporting period (hereinafter referred to as the *total pension liability*)
- An amount equal to the plan assets, net of other plan liabilities, as measured by the pension plan for financial statement recognition purposes (including investments at fair value), that are available for payment of pension benefits as they come due, as of the end of the employer's financial reporting period (hereinafter referred to as *plan net assets available for pension benefits*).

The latter component represents the preliminary views of the Board, discussed in Chapters 2 and 3, that for financial reporting purposes, the pension plan is primarily responsible for a portion of the total pension liability—limited to the amount of plan net assets available for pension benefits—and that a sole or agent employer is primarily responsible for, and should recognize as its liability, the residual net pension liability, if any.

2. This chapter summarizes the Board's preliminary views regarding basic issues pertaining to measurement of the total pension liability by a sole or agent employer for accounting and financial reporting purposes, including:

- Whether the projection of benefit payments should include expectations of future changes
- On what basis the discount rate used to measure the present value of projected benefit payments should be determined
- What method or methods should be used to attribute the present value of projected benefit payments to past, current, and future financial reporting periods
- Over what periods the present value of projected benefit payments for an employee should be attributed.

3. Measurement of the present value of projected benefit payments also affects measurements of the service-cost component of pension expense. This issue is discussed further in Chapter 5.

## Projection of Expected Future Changes

4. The projection of benefit payments necessitates the use of many assumptions about factors that will affect the amount of pension benefits an employee or his or her beneficiaries ultimately will receive in retirement. Examples of such factors include turnover, disability, and mortality. In addition, consideration is given to the terms of the pension plan, which frequently include pension formulas based in part on an employee's salary level(s) and years of service and may include provisions for certain adjustments in

benefit levels (for example, cost-of-living adjustments [COLAs]) that affect benefit payments after an employee's retirement date. Plans also may include provisions related to vesting, disability and death benefits, early-retirement incentives, step-rate changes, and service caps. If expectations of future changes are not included in projections of benefit payments, the effects of a future change (for example, an employee earns an additional year of service credit, satisfies vesting provisions, or receives a salary increase) first will be reflected in the period in which the event occurs.

5. The Board believes that the annual employment exchanges between a state or local governmental employer and its employees appropriately are viewed for accounting and financial reporting purposes within the context of the expectation of a continuing employment relationship spanning each employee's career with the employer. A defined benefit pension plan is intended, in part, to support the continuation of an ongoing employment relationship. Therefore, the Board believes that pension measurement techniques generally should incorporate probability-weighted expectations about the occurrence of future events that will affect the ultimate amount of pension benefit payments an employee or his or her beneficiaries will receive in retirement to the extent that inclusion of the effects of such events is consistent with the definition of a liability (discussed in Chapter 3) and the effects are reasonably estimable.

6. Consistent with this belief, **it is the Board's preliminary view that the effects of each of the following types of future changes should be included in the projection of benefit payments for accounting and financial reporting purposes to the extent discussed below:**

- **Automatic COLAs**
- **Projected future ad hoc COLAs when relevant facts and circumstances indicate that such COLAs are not substantively different from automatic COLAs**
- **Projected future salary increases in circumstances in which the pension benefit formula is based on future compensation levels**
- **Projected future service credits, both in determining an employee's probable eligibility for benefits and in the projection of benefit payments in circumstances in which the pension benefit formula is based on years of service.**

## Automatic COLAs

7. Automatic COLAs are those that explicitly are part of the terms of the pension plan and, therefore, constitute part of the employment exchange each period. In the context of these preliminary views, automatic COLAs are any COLAs that occur without a requirement for a decision to grant by a responsible authority, including those for which the amounts are determined by reference to a specified experience factor (such as the earnings experience of the plan) or to another variable (such as an increase in the consumer price index). Because automatic COLAs are part of the employment exchange, the Board believes that they are an integral part of an employer's present obligation to its employees to provide pension benefits. Therefore, the Board believes that the effects of automatic COLAs should be included in the projection of benefit payments for accounting and financial reporting purposes.

## Ad Hoc COLAs

8. In contrast to automatic COLAs, which are adjustments explicitly included in the terms of the pension plan, ad hoc COLAs (as distinguished by the Board for purposes of the preliminary views discussed in this chapter) are discretionary in the sense that each occurrence requires a decision to grant by a responsible authority. Accordingly, as a general proposition, the Board believes that future ad hoc COLAs are not part of the plan terms under which employees exchange their services for benefits in any given financial reporting period. Therefore, the projected effects of future ad hoc COLAs generally should not be included in the projection of benefit payments for accounting and financial reporting purposes.

9. However, the Board believes that there may be circumstances in which it would be reasonable to conclude—for example, based on an employer's demonstrated pattern of practice of granting serial ad hoc COLAs—that future ad hoc COLAs are not substantively different from automatic COLAs. When consideration of the relevant facts and circumstances supports that conclusion, the Board believes that to appropriately reflect the terms of the exchange between the employer and its employees, such future ad hoc COLAs should be included, as an automatic COLA would be, in the projection of benefit payments for accounting and financial reporting purposes.

## Salary Increases

10. The terms of many defined benefit pension plans base the amount of an employee's pension benefits in part on the employee's final salary level or final-average salary level. When that is the case, the Board believes that the projection of benefit payments should include expected future salary increases because final-pay or final-average-pay-based benefits effectively incorporate future salary levels into the terms of employment exchanges throughout an employee's career. The Board considered but rejected the view that measurement of the total pension liability should take into consideration only employees' salaries to the date of the measurement. As noted above, the Board believes that annual employment exchanges between the employer and the employee should be viewed as occurring as part of an employee's career-long employment relationship with the employer. The Board believes that including an expectation of future salary increases in the projection of benefit payments better reflects this view and, therefore, contributes to a more decision-useful attribution of the service-cost component of pension expense over the course of an employee's career.

## Service Credits

11. The terms of many defined benefit pension plans include service credits that the employee earns for each year of eligible service to the employer as a factor affecting the ultimate amount of an employee's pension benefits. For example, the terms of a plan may provide for service credits for each year of service up to a maximum of 30 years and provide the employee or his or her beneficiaries with annual payments in retirement equal to 2 percent of final salary for each accumulated service credit. Plan terms also might

include vesting provisions that require an employee to complete a certain number of years of service in order to be eligible to receive a pension benefit.

12. As with future salary increases, the Board evaluated the relevance of future service credits in the projection of benefit payments within the context of the annual employment exchanges occurring as part of an employee's career-long employment relationship with the employer. Within this context, the Board believes that future service credits should be considered in two ways in the projection of benefit payments. First, if plan terms contain provisions that an employee is required to meet to qualify for benefits (for example, vesting provisions), expected future service credits should be considered for purposes of forming an assumption about whether employees will qualify. Second, in plans in which the amount of benefit payments is affected by service credits earned by the employee, assumptions about future service credits should be included in the projection of benefit payments.

13. As with the inclusion of future salary increases, the Board recognizes that the inclusion of future service credits generally would result in measurements of service costs and of the total pension liability that differ from those that would result if measurements were based on a strict application of the terms of the plan. However, the Board believes that the inclusion of both types of future changes is consistent with its focus on measuring the service-cost component of pension expense and the contribution of pension expense to the cost of government services from the perspective of career-long employer–employee relationships.

## Discount Rate

14. **The preliminary view of the Board is that the discount rate for accounting and financial reporting purposes should be a rate that reflects:**

**a. The long-term expected rate of return on plan investments to the extent that current and expected future plan net assets available for pension benefits are projected to be sufficient to make benefit payments**

**b. A high-quality municipal bond index rate beyond the point at which plan net assets available for pension benefits are projected to be fully depleted.**

The discount rate should be the single rate that, when applied to projected benefit payments, results in a present value of those payments equivalent to the sum of (1) the present value of projected benefits expected to be paid from current and expected future plan net assets, discounted at the long-term expected rate of return on plan investments, and (2) the present value of projected benefit payments that are expected to be made after plan net assets are projected to be fully depleted, discounted using a high-quality municipal bond index rate.

15. The preceding view is based on the concept that the total pension liability can be viewed as derived from two benefit payment streams that have different measurement implications. These two streams are (a) benefit payments that are projected to be paid to employees currently in the plan from plan net assets (held in trust) available for pension

benefits, adjusted for relevant projected increases and decreases, and (b) benefit payments to those employees that are expected to occur beyond the point at which the plan net assets available for pension benefits are projected to be fully depleted.

## Discounting Projected Benefit Payments for Which Plan Net Assets Are Projected to Be Available

16. To the extent that plan net assets available for pension benefits have been accumulated to date in the pension plan and are reasonably expected to grow during the time when benefit payments are being made from those assets, the Board believes that the present value of the employer's projected sacrifice of resources is effectively modified (reduced) by the expected return on investments.

17. The analysis of projected cash outflows and inflows required to determine the portion of the projected benefit payments that should be discounted using the long-term expected rate of return involves assumptions about future events, including the projected amounts of future contributions to the plan from various sources, the long-term expected return on plan net assets, and administrative expenses not included in the projected return on plan investments. Because the projection of benefit payments for this purpose includes future service costs, the Board believes it is appropriate to include consideration of projected future contributions from all sources related to funding the benefits of employees currently in the plan—for example, the employer and current employees. The projection of future employer contributions for this purpose should reflect a reasonable expectation of future employer contribution levels for current employees and should consider factors such as the employer's stated contribution policy and recent contribution pattern. In addition, although investment experience fluctuates from period to period, the Board believes that over the long term, investment returns above or below the long-term expected rate of return will tend to offset to a great extent. The Board notes that the experience of public pension plans over many years has been that the plans have achieved earnings that, on average, have approximated their long-term earnings assumptions, despite short-term fluctuations. The Board believes, therefore, that discounting based on the long-term expected rate of return is appropriate, subject to the following conditions:

a. The rate used should be a reasonable estimate of the rate at which plan net assets are expected to grow, over a term commensurate with the accounting measurements for which the rate is used, as a result of investment earnings.
b. The use of the long-term expected rate of return should be limited by the extent to which plan net assets are projected to be available to provide for payment of benefits.

18. The Board considered but rejected various other rates, based on other liabilities, suggested as possible surrogates for the rate implicit in the exchange between the employer and employees. These included:

- A risk-free rate of return
- A rate at which an individual employer could issue high-quality municipal bonds (tax-exempt or taxable), taking into account the credit rating of that employer's debt and,

potentially, the effects of changes in the perceived quality of that employer's debt on its market value to holders or potential holders
- A high-quality municipal bond index rate reflective of the rate at which state and local governments generally could issue high-quality municipal bonds.

None of these alternatives was consistent with the view expressed above that the present value of projected benefit payments should reflect an expectation of the employer's projected sacrifice of resources, reduced by the expected return on investments.

## Discounting Projected Benefit Payments for Which Plan Net Assets Are Not Projected to Be Available

19. To the extent that projected benefit payments are expected to occur beyond the projected point of depletion of plan net assets available for pension benefits, the Board believes that the projected payments should be discounted in the same manner as unfunded long-term liabilities of the employer generally. Because the terms of exchange between the employer and its employees pertaining to the deferred payment of earned pension benefits generally do not specify a rate of interest, it is necessary to impute a rate for purposes of discounting the projected benefit payments to their present value in order to measure service costs to date and the total pension liability.

20. The Board considered but rejected use of the long-term expected rate of return on plan investments for purposes of discounting projected benefit payments that are expected to occur beyond the projected point of depletion of plan net assets available for pension benefits because the long-term rate of return is not relevant to an unfunded exchange of benefits for employee services. The Board also considered the various rates identified in paragraph 18, based on other liabilities, as potential surrogates for the rate implicit in the exchange.

21. The Board believes that although the risk of nonpayment of the total pension liability by state and local governments on the whole is low, the liability cannot be assessed to be free of the risk of renegotiation or adjustment through Chapter 9 bankruptcy proceedings in the event that a government comes under sufficient fiscal distress. Moreover, from the standpoint of employees, an employer's total pension liability involves uncertainty regarding the number and amounts of payments that ultimately will be received, unlike a bond. Accordingly, the Board rejected the use of a notionally risk-free surrogate such as the interest rate on U.S. Treasury securities to establish the discount rate for projected pension benefit payments for which plan net assets are not expected to be available.

22. The Board also considered but rejected the use of the rate at which a government could issue high-quality bonds, taking into consideration that government's individual credit rating. The Board does not believe that recognizing changes in the notional fair value of the total pension liability (effectively, the value of the liability to holders or potential holders of the liability) as a result of changes in the credit quality of the issuer would be consistent with the objective of accountability. For example, if an individual government's credit rating were to be downgraded, the fair value of that government's

liabilities, including the net pension liability, would decline, other things being equal, as a reflection of the greater risk to existing or potential counterparties surrounding receipt of payment. The accounting effect for the government if the effects of the downgrade were recognized would be to reduce the carrying value of the liability, thereby increasing the government's net assets, and to recognize an inflow of resources. However, the Board believes that such a change in credit rating, in either direction, would not change the underlying liability to employees for defined pension benefits for which the government is accountable, notwithstanding changes in the value of that liability to holders. Accordingly, the Board emphasizes it does not believe that fair valuing the total pension liability for accounting and financial reporting purposes is a relevant objective.

23. The Board, therefore, believes that the discount rate for projected benefit payments for which plan net assets are not projected to be available should be based on an index rate for governmental bonds of a high quality commensurate with the quality of the pension liability.

## Attribution of the Present Value of Projected Benefit Payments to Periods

24. **It is the preliminary view of the Board that for purposes of determining the total pension liability of a sole or agent employer, as well as determining the service-cost component of pension expense (discussed in Chapter 5), the present value of projected benefit payments for an employee should be attributed to that employee's expected periods of service as a level percentage of payroll using the method described in the current standards as the entry age actuarial cost method.**

### Use of a Single Method for Accounting and Financial Reporting Purposes

25. Pension plans typically differ from one another in many ways, including plan terms and the demographic characteristics of the covered groups, for example. These preliminary views reflect the idea that pension accounting and financial reporting measurements by each employer should incorporate the applicable plan terms as well as demographic and economic assumptions reflective of applicable facts and circumstances. In that way, whatever differences exist with regard to such facts and circumstances will be taken into consideration, and the resulting financial reporting will measure the impact of pensions on the elements of each employer's financial statements.

26. Consideration of such plan-specific characteristics, as well as employer-specific facts, circumstances, objectives, and constraints other than the terms of the plan or the demographics of the plan membership, may contribute to the adoption by individual employers of varying policies and practices related to funding, for example. However, the Board does not believe that differences among employers with regard to funding or other policy choices support a need for multiple methods of attributing the present value of projected benefit payments to periods for accounting and financial reporting purposes. The Board believes that specifying a single method by which the present value of projected benefit payments should be attributed to past, current, and future periods will eliminate an unnecessary accounting-related (rather than relevant facts-and-

circumstances-related) source of variation in financial reporting. As a result, specifying a single attribution method will benefit report users by improving the comparability and understandability, and reducing the complexity, of information reported about the impact of pensions on the elements of employers' financial statements.

27. The Board has considered the incremental cost of the use of a specified attribution method for accounting and financial reporting purposes for employers that choose to use a different method for funding purposes. Information received by the Board from members of the actuarial community indicated that the potential incremental cost of having an actuary apply two cost methods for different purposes would be relatively small because of the nature of the incremental work that would be required. The Board's understanding is that the most expensive stage of an actuarial valuation typically occurs prior to the application of a cost attribution method and irrespective of the method to be used. That stage involves the projection of benefit payments, which typically is the most time-consuming process because of the need to develop "clean" census data, model plan terms, and make or apply appropriate assumptions. After that stage, attribution of portions of the total present value of projected benefit payments is a mathematical process, commonly accomplished using existing computer technology.

## Choice of the Entry-Age/Level-Percentage-of-Payroll Attribution Method

28. In the process of selecting an attribution method for accounting and financial reporting purposes, the Board considered the suitability of each of the actuarial cost methods permitted by Statement 27— aggregate, attained age, entry age, frozen attained age, frozen entry age, projected unit credit, and unprojected unit credit.

29. The unprojected unit credit actuarial cost method, which is permitted by Statement 27 "for plans in which benefits already accumulated for years of service are not affected by future salary levels" (a condition that generally does not apply in public pension plans), effectively was eliminated as a result of the Board's preliminary view that the projection of benefit payments for service-cost and liability measurement purposes should include projected future salary increases and service credits.

30. Two principal criteria were used to evaluate the suitability of the other actuarial cost methods for financial reporting purposes. First, to be useful for financial reporting purposes an attribution method should assign portions of the present value of projected benefit payments to past periods, to the extent that benefits relate to services received from employees in past periods. This is because an employer's total pension liability at the reporting date will be the total of all amounts attributed to past periods and the current period. Several methods permitted under Statement 27 do not result in a liability measure with this characteristic; those are the aggregate, frozen attained age, and frozen entry age actuarial cost methods.

31. Under the aggregate actuarial cost method, the unfunded portion of the present value of projected benefit payments is attributed entirely to current and future periods. One of the results of the manner in which this method attributes the present value of projected benefit payments to periods is that the (implied) liability is always set equal to the value of

plan assets. Therefore, under this method, the employer is never considered to have a net liability for past periods—even in the case of a plan with no plan assets. The two frozen initial liability actuarial cost methods currently permitted for purposes of accounting and financial reporting calculate an initial unfunded liability and update that unfunded liability each period for the service cost, employer contributions, and interest. The initial liability also would be updated to reflect the effects of changes in actuarial assumptions, changes in actuarial methods, and changes in benefits. These methods, however, attribute the effects of actuarial gains and losses only to the current and future periods but not to past service.

32. The second criterion applied to the assessment of potential attribution methods is that, to be appropriate for accounting and financial reporting of service cost and the total pension liability, the method selected should employ the same method of attributing portions of the present value of projected benefit payments to past periods as it does to the current and future periods. The frozen initial liability actuarial cost methods generally do not have this characteristic as long as the initial (frozen) liability remains. Further, once the initial liability is no longer relevant, the frozen methods function essentially as the aggregate method, described above. In addition, another of the methods currently permitted under Statement 27—the attained age actuarial cost method—does not use the same approach to determine the portion of the present value of projected benefit payments attributable to past periods and those portions attributable to the current and future periods.

33. The application of the preceding criteria narrowed the potential choices to two actuarial cost methods—projected unit credit and entry age—that have both characteristics. The two methods, however, attribute service cost and interest in different patterns over time.

a. In the absence of explicit plan terms to the contrary, the projected unit credit actuarial cost method, as usually applied on a level-dollar basis, attributes each projected benefit payment to an employee's projected periods of service in equal units. For example, if an employee is expected to have 25 years of service at retirement, the present value of 1/25 of each projected benefit payment would be attributed to each period of service. Because each successive period of service is one period closer to the period of payment of the projected pension benefits, the amounts attributed to periods of service increase in an ascending curve that is steeper than an employee's salary curve if the discount rate is greater than the projected rate of salary increases. This is because the present value of the service-based units of benefit payments attributed to each period typically will increase more rapidly than salary as an employee approaches the point at which pension benefits will be fully earned.
b. The entry age actuarial cost method generally calculates the present value of projected benefit payments discounted to the employee's entry age and then calculates the level amount that, if attributed over the period from entry age to retirement and combined with interest that is expected to accrue over that period on amounts attributed to past service, will result in accumulated past service cost at retirement that is equal to the present value of projected benefit payments at

retirement. The entry age actuarial cost method can result in annual attributions that are level in dollar amounts or as a percentage of payroll. However, the entry age actuarial cost method typically is applied in a way that attributes service cost to periods as a level percentage of projected payroll, in which case, it assigns service cost to periods in amounts that bear a consistent relationship to the employee's projected salary levels. Under the level-dollar approach, service cost decreases as a percentage of an employee's salary over the course of his or her career because projected employee salary growth generally exceeds projected inflation.

The Board considered the attribution pattern that results from application of the entry age actuarial cost method to be more representative of its view of the employment relationship as an ongoing series of exchanges within the context of an employee's career with the employer. In addition, as compared to level-dollar attribution, the Board believes that level-percentage-of-payroll attribution is more reflective of its view that the value assigned to the pension benefits exchanged for services each year over an employee's career should bear a consistent relationship to the employee's base salary level.

## Use of Service Life as the Attribution Period

34. As discussed above, for purposes of accounting and financial reporting, the Board believes that the present value of projected benefit payments for each plan member should be attributed over the member's expected service life. The Board considers use of service life for this purpose to be appropriate within the context of its view of the employment relationship as an ongoing series of exchanges over the employee's career with the employer.

# CHAPTER 5—ATTRIBUTION OF CHANGES IN THE NET PENSION LIABILITY TO FINANCIAL REPORTING PERIODS BY A SOLE OR AGENT EMPLOYER

1. This chapter summarizes the Board's preliminary views regarding the amount of projected pension benefits attributed to a period of employee service (service cost) and other changes affecting the net pension liability of a sole or agent employer for expense recognition purposes. Changes in an employer's net pension liability from period to period can occur as the result of several types of transactions or other events, including:

- Employee services during the period
- Interest on the beginning total pension liability
- Differences between expected and actual experience with regard to economic and demographic factors affecting measurement of the total pension liability
- Changes of assumptions regarding the expected future behavior of economic and demographic factors affecting measurement of the total pension liability
- Changes of plan terms that affect the amount of pension benefits associated with employee services in past periods
- Changes in plan net assets available for pension benefits.

## Applicable Financial Reporting Concepts

### Consumption of Net Assets

2. Consistent with the Board's preliminary view that the net pension liability meets the criteria for liability recognition by a sole or agent employer, any increase (decrease) in the net pension liability during a financial reporting period represents what Concepts Statement 4 terms a *consumption (acquisition) of net assets* of the employer. The principal issue in regard to pension expense recognition, then, is whether the consumptions (acquisitions) of net assets resulting from the occurrence of these types of pension-related transactions or other events during the current period are (a) applicable to the current reporting period (that is, they are *outflows [inflows] of resources,* or components of pension expense currently) or (b) applicable in some part to a future reporting period or periods (that is, they are in some part *deferred outflows of resources* or *deferred inflows of resources* that should be recognized as components of pension expense in a future period or periods).

3. Concepts Statement 4 provides the following definitions of the elements *outflow of resources, inflow of resources, deferred outflow of resources,* and *deferred inflow of resources:*

> An *outflow of resources* is a consumption of net assets by the government that is applicable to the reporting period (paragraph 24; footnote omitted).
>
> An *inflow of resources* is an acquisition of net assets by the government that is applicable to the reporting period (paragraph 28).

A *deferred outflow of resources* is a consumption of net assets by the government that is applicable to a future reporting period (paragraph 32).

A *deferred inflow of resources* is an acquisition of net assets by the government that is applicable to a future reporting period (paragraph 34).

### Interperiod Equity

4. Paragraph 27 of Concepts Statement 4 provides that "for resource flows statements prepared using the economic resources measurement focus, the period to which an outflow (or inflow) of resources is applicable is determined using the concept of *interperiod equity*." In the context of the GASB's financial reporting concepts, interperiod equity refers specifically to "the state in which current period inflows of resources [acquisitions of net assets] equal current period costs of services." The concept is viewed, not as a goal that is expected to be met, but as a metric, or benchmark, relevant to assessment of the relationship between a government's cost of services and its resource inflows for any given financial reporting period.

5. Accordingly, the Board believes that issues related to the attribution of the effects of pension-related transactions and other events to financial reporting periods for expense recognition purposes are a subset of larger issues related to the measurement of the cost of government services, of which pension expense is a part.

## Recognition of Components of the Change in the Net Pension Liability

### Service Cost and Interest on the Beginning Total Pension Liability

6. The Board's preliminary view that the present value of projected benefit payments should be attributed to financial reporting periods using the entry age actuarial cost method applied on a level-percentage-of-payroll basis was discussed in Chapter 4. As a corollary, **it is the preliminary view of the Board that the service cost component of pension expense should be the amount attributed to the current period by the entry age actuarial cost method. In addition, interest on the beginning total pension liability should be recognized as pension expense in each period.**

7. As discussed previously, the Board believes that the attribution method described in paragraph 6 is appropriate for several reasons, including that the method attributes service cost to each period of an employee's expected service in a way in which that component of pension expense is proportionate to projected salary levels over the employee's career. This is consistent with the Board's belief that the annual employment exchange should be viewed in the context of an ongoing employer–employee relationship spanning an employee's career. Further, in the Board's view, service cost determined in this way and interest cost are applicable to the reporting periods in which services are received or interest is incurred and, therefore, should be recognized in those periods as pension expense.

## Effects of Other Changes in the Total Pension Liability

8. **It is the Board's preliminary view that the effects of changes in the total pension liability resulting from the following types of events should be recognized as components of pension expense over periods representative of the expected remaining service lives, if any, of individual employees, considering separately (a) the aggregate effect on the liabilities for active employees to which the change applies and (b) the aggregate effect on the liabilities for inactive employees:**

- **Differences between expected and actual experience with regard to economic and demographic factors affecting measurement of the total pension liability**
- **Changes of assumptions regarding the expected future behavior of economic and demographic factors affecting measurement of the total pension liability**
- **Changes of plan terms that affect the amount of pension benefits associated with employee services in past periods.**

To the extent that such changes relate to past periods of service of active plan employees, the amortization period should be an average expected remaining service life with weighting to approximate the result that would be obtained if such changes were amortized individually for each active employee. To the extent that these types of changes relate to past periods of service of inactive (including retired) employees, such changes would be recognized as pension expense immediately in the period of the change. The Board believes that it is appropriate to apply a single method of accounting and financial reporting to all three of these types of changes in an employer's total pension liability in order to avoid unnecessary complexity.

9. Because benefit payments relate to future periods, measurement of the total pension liability necessarily is dependent upon a number of estimates and assumptions about future events. If events do not occur as expected, differences occur in comparison to expected results. Also, if expectations about the future behavior of demographic or economic factors have changed, the adoption of new assumptions will result in changes in the total pension liability. The total pension liability also will be changed if the benefit plan is changed; for example, if retroactive benefit increases are enacted. Such differences or changes affect the total pension liability to the extent that they are attributed to services received in past periods. The effects can be recognized as either (a) pension expense in the current period or (b) deferred pension outflows (inflows) with portions recognized as pension expense over one or more future periods. The Board believes that, as they relate to an employee who continues to provide services, fully recognizing the effects of differences between expected and actual results, assumption changes, or plan changes as expense in the periods in which they occur would result in a pattern of pension expense that would be inconsistent with the view that pensions are part of a career-long relationship between the employer and the employee. The Board believes that an approach that recognizes these types of changes as expense over future reporting periods in which the employee continues to provide services is more consistent with this view. Further, the Board considered permitting deferred recognition of the effects of such changes as deferred outflows (inflows), with recognition as expense of some or all deferred amounts only if the cumulative deferral exceeds an established corridor around the total pension

liability. However, the Board did not find there to be adequate evidence to support a view that changes of this nature would be expected to offset over time and, thus, did not believe that such a deferral approach would be appropriate.

10. Requiring expense recognition of changes over the expected remaining service lives of individual employees would result in recognition of pension expense attributed to each employee over the employee's career. Moreover, if such changes occur after an employee's retirement or separation from service, this approach would result in immediately recognizing the effects of such changes as pension expense in the period in which they occur. However, the Board is aware that additional complexity would result from a requirement that would necessitate the tracking of amortization bases and periods by member and for each period. Therefore, to the extent that such changes are related to active employees, the Board believes that amortization of the aggregated employees' changes over a period equal to the weighted average of the affected active employees' expected remaining service lives is an approach that appropriately would take into account cost–benefit considerations.

## Changes in Plan Net Assets Available for Pension Benefits

11. Changes in the plan net assets available for pension benefits would not affect the total pension liability but would affect an employer's net pension liability, as a result of the Board's preliminary view that the employer's primary responsibility for the total pension liability is reduced to the extent that plan net assets are available to pay benefits. Accordingly, an employer's pension expense would include the effects of (a) changes in the plan net assets available for pension benefits associated with investment experience and (b) changes other than investment experience.

12. **It is the Board's preliminary view that the effects on the net pension liability of projected earnings on plan investments, calculated using the long-term expected rate of return, should be included in the determination of pension expense in the period in which the earnings are projected to occur. Earnings on plan investments that differ from the long-term expected rate of return should be reported as deferred outflows (inflows) unless cumulative net deferred outflows (inflows) resulting from such differences are more than 15 percent of the fair value of plan investments. If cumulative net deferred outflows (inflows) are more than 15 percent of the fair value of plan investments at the end of a financial reporting period, the amount of cumulative net deferred outflows (inflows) that is greater than 15 percent of the fair value of plan investments should be recognized as an addition to (reduction of) pension expense immediately.**

13. Pension investments are made with a long-term earnings horizon. However, returns on investment can fluctuate significantly from period to period. For example, in one recent study,[1] the group of public pension plans examined had median annualized investment returns of nearly 20 percent for the most recent year, below negative 1 percent for the

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[1]National Association of State Retirement Administrators, *NASRA Issue Brief: Public Pension Plan Investment Return Assumptions,* March 2010, page 1 (citing Callan Associates).

most recent 3-year period, and 9.25 percent over the most recent 25-year period. Over that same 25-year period, the median assumed rate of return was 8.0 percent. The Board believes that to the degree that the assumption applied in the pension measurements is reflective of a reasonable expected long-term rate of return on plan investments, differences between expected and actual investment experience generally will offset over time. That is, in any one period actual returns may be different from expected returns, but over time, earnings in excess of expectations will be offset by earnings shortfalls in future years, and vice versa. In such circumstances, the Board believes that reflecting in an employer's pension expense differences that are expected to be offset by future changes, and therefore never realized, would significantly reduce the usefulness of measures of the total cost of government services on a periodic basis. Therefore, the Board rejected an approach in which all differences between expected and actual investment experience would be recognized as expense in the periods in which they occur. The Board believes, however, that if cumulative differences become too large as a percentage of plan investments, reversal of differences between expected and actual returns may not occur until periods relatively far into the future. Therefore, in such circumstances, amounts exceeding a specified corridor should be recognized as expense in order to avoid deferral beyond a reasonable timeframe.

14. In regard to the width of the corridor within which cumulative differences should be recognized as deferred outflows (inflows), the Board considered feedback from respondents to the Invitation to Comment who suggested use of a corridor method for this purpose, as well as standards issued by other standards setters on this issue. Potential corridors identified through those sources were 10 percent and 20 percent. The Board also considered examples of application of the corridor method to 2 sets of historical data and evaluated the frequency with which deferred balances would have exceeded a 10-percent, a 15-percent, and a 20-percent corridor around plan net assets available for pension benefits. Based on these results, the Board concluded that use of a 10-percent corridor would not provide for adequate deferral of differences that are expected to be offset in future periods and that a 20-percent corridor would provide for long-term deferral of differences that may not be offset by changes in subsequent periods until relatively far into the future. In the Board's view, a 15-percent corridor should provide a reasonable opportunity for period-to-period differences between expected and actual returns to offset.

15. The Board also considered several alternatives to the corridor approach described above, including use of closed-period amortization of differences between actual and expected returns over a specified number of periods. Variations on closed-period amortization that additionally would have applied a corridor approach also were discussed, for example, deferral and amortization of amounts within a corridor or deferral of amounts within a corridor with amortization of amounts exceeding the corridor. Each of the methods involving closed-period amortization of differences between expected and actual returns would have ensured that differences were reflected in pension expense over a specified number of years. However, the Board rejected use of these methods because they are not consistent with its underlying belief that such differences are expected to offset over time, as generally has been demonstrated historically.

16. **It is the Board's preliminary view that the effects of changes in the plan net assets available for pension benefits other than those associated with investments should be recognized by employers as additions to or reductions of pension expense in the period in which the changes occur.** Such changes include employer contributions, employee contributions, and plan administrative expenses.

# CHAPTER 6—RECOGNITION BY A COST-SHARING EMPLOYER

1. This chapter summarizes the Board's preliminary views regarding accounting and financial reporting by employers in cost-sharing multiple-employer pension plans (cost-sharing employers). Pension plans, including cost-sharing pension plans, typically are long-term, relatively stable arrangements in which the participating employers also are long-lived entities. However, in a single-employer or agent multiple-employer plan, each employer bears separately the financial risks associated with its obligation to its employees to provide defined pension benefits as part of employment exchanges. In addition, in those plans, plan assets (or a separately accounted-for interest in assets pooled for investment purposes) are dedicated to payment of pension benefits to the employees of a specific employer. In contrast, characteristic features of cost-sharing plans are:

- The employers pool, or share, their obligations to their employees to provide defined pension benefits as part of employment exchanges.
- Plan assets also are pooled, so that assets contributed by any employer may be used to pay benefits to any plan member.
- Consistent with the preceding features, a single actuarial valuation is performed at the plan, or collective, level.
- The plan bills the employers for contributions, called contractually required contributions, generally in proportion to some base, such as covered payrolls.

2. The Board considered in what ways the characteristic features described above should affect the measurement and recognition of a pension liability, pension expense, and deferred pension outflows (inflows) by a cost-sharing employer. The Board believes that in a cost-sharing plan the unfunded liability for pension benefits is a liability of the employers collectively, rather than a liability of the pension plan. **It is the Board's preliminary view that each participating employer in a cost-sharing plan should recognize its estimated proportionate share of the collective net pension liability, pension expense, and deferred pension outflows (inflows).** This view is discussed in more detail in the paragraphs that follow.

## Cost-Sharing Employers, Employees, and the Pension Plan

3. The Board believes that the origin of defined benefit pension obligations is the same without regard to the plan structure used. That is, as is the case with sole and agent employers, cost-sharing employers individually incur obligations to provide pension benefits to their respective employees as part of the total compensation exchanged for their respective employees' services. What is distinctive, however, is that as a way of paying for, administering, and delivering benefits, cost-sharing employers agree to share their financial risks associated with providing defined pension benefits to their employees and to contribute to a pooling of assets dedicated to payment of benefits. The Board believes that this agreement creates an obligation that is best understood as a shared obligation of the employers collectively, rather than as an obligation of the pension plan.

4. As is the case with single-employer and agent multiple-employer plans, the Board believes that a cost-sharing plan can be regarded as primarily responsible for the

obligation in part, for financial reporting purposes, but only to the extent that plan net assets available for benefits have been accumulated. In the Board's view, the employers collectively remain primarily responsible for the unfunded obligation. This view is supported by the observation that the cost-sharing plan is not financially self-sufficient but continually is reliant on employer contributions as the residual source of funding for promised benefits. Stated differently, the cost-sharing employers have an ongoing responsibility to financially support the benefits created by their collective employment exchanges with their employees.

5. The Board also believes that the collective unfunded obligation is a present obligation to sacrifice resources that the employers collectively have little or no discretion to avoid and that is reliably measurable.

## Measurement of the Cost-Sharing Employers' Collective Net Pension Liability, Pension Expense, and Deferred Pension Outflows (Inflows)

6. Because of the benefit-risk-sharing and asset-pooling features of a cost-sharing plan, the Board believes that measurements for accounting and financial reporting purposes necessarily should begin with a single periodic measurement at the collective level, consistent with the frequency and timing provisions discussed in Chapter 7 of this Preliminary Views. The Board's preliminary views about projection of benefit payments, determination of the discount rate, and attribution of the present value of projected benefit payments to financial reporting periods by sole and agent employers should be similarly applied to measurements for cost-sharing employers collectively. In addition, the measurement products—net pension liability, pension expense, and deferred outflows (inflows)—should be determined in the same manner for cost-sharing employers collectively as they are for sole and agent employers individually because the Board believes that the financial effects of pensions are substantively similar.

## Individual Cost-Sharing Employer Accounting and Financial Reporting

### Pension Liability Recognition

7. As discussed previously, the Board believes that, like a single-employer or agent multiple-employer plan, a cost-sharing pension plan cannot appropriately be assigned primary responsibility, for financial reporting purposes, for the collective total pension liability created by employment exchanges of the participating employers beyond the amount of plan net assets available for benefits. Accordingly, the Board believes that in all cases the net pension liability should be accounted for as the primary responsibility of the employer or, in the context of a cost-sharing plan, the employers collectively.

8. Further, the Board believes that each employer in a cost-sharing plan is primarily responsible for a part of the collective net pension liability representing that employer's implicit share of the pooled benefit risks and plan assets, rather than its individual benefit risk or separately identifiable plan assets. Therefore, each cost-sharing employer should recognize its proportionate share of the collective net pension liability. The Board plans to discuss further the selection of the methodology that should be used for determining each

employer's share after the issuance of this Preliminary Views. The Board is considering, as a possible method, an employer's share of the total annual contractually required contributions to the plan. The Board believes that this method would support a conclusion that an individual employer's allocated share of the collective net pension liability would meet the definition of a liability and be measurable with sufficient reliability for recognition as a liability in the financial statements of individual cost-sharing employers. The Board also remains open to the possibility that other methods for allocation may exist that would result in a sufficiently reliable measurement of each employer's net pension liability to support recognition.

9. The Board considered an alternative approach that would have resulted in enhanced disclosure requirements related to a cost-sharing employer's participation in the cost-sharing plan rather than recognition of an employer's allocated share of the collective net pension liability. However, it believes that a disclosure approach would be contrary to the concept expressed in Concepts Statement 3 that disclosure of information is not an adequate substitute for recognition in basic financial statements when an element meets the criteria for recognition. Further, the Board believes that the employer's allocated share is not essentially different from the net pension liability of a sole or agent employer, even though the measurement approach (measurement at the collective level followed by allocation) is necessarily modified to take into consideration the benefit-risk-sharing and asset-pooling features that are characteristic of cost-sharing plans.

10. As another alternative to recognition of the employer's proportionate share of the collective net pension liability, the Board considered an approach similar to that in the current pension reporting model in which cost-sharing employers report a pension liability to the extent that contributions to the pension plan differ from the contractually required contributions assessed by the plan. However, that approach was rejected because it is inconsistent with the Board's view that the pension plan cannot appropriately be assigned primary responsibility for the collective pension liability created by employment exchanges of the participating employers beyond the amount of plan net assets available for pension benefits.

## Recognition of Pension Expense and Deferred Pension Outflows (Inflows)

11. The Board believes that a proportionate share of the effects of transactions and other events that change the collective net pension liability should be allocated to each individual cost-sharing employer in order to fully account for each employer's pension expense and deferred pension outflows (inflows) incident to participation in the cost-sharing plan. In principle, each employer would recognize as pension expense its allocated share of the collective pension expense, and as deferred pension outflows (inflows) its allocated share of the collective deferred pension outflows (inflows). In practice, this would be possible, without adjustment, only if all employers' proportionate shares of the collective net pension liability remained unchanged from year to year. However, as discussed further below, the Board anticipates that individual employers' proportionate shares, on whatever basis ultimately is required, may change from period to period. Accordingly, the Board anticipates that an individual employer may need to recognize, in addition to its allocated share of the current-period collective pension expense and

collective changes in deferred pension outflows (inflows), an adjustment to reflect the period-to-period change in its share of the totals.

### Recognition of Changes in a Cost-Sharing Employer's Net Pension Liability Due to Changes in the Employer's Proportionate Level of Participation in a Cost-Sharing Plan

12. Unlike a sole or agent employer, a cost-sharing employer can experience changes in its net pension liability solely as a result of the effects of period-to-period changes in its proportionate allocation percentage. Further, the degree and the direction of the change in an employer's proportionate allocation percentage from period to period may vary. One of the implications of a change in an employer's proportionate share is that the cumulative effects of having recognized a different proportionate share in past periods need to be reflected in the amounts reported as expense or as deferred outflows (inflows) in the current period.

### Cost–Benefit Considerations Related to Allocations to Individual Employers

13. The Board notes that the measurements required by these preliminary views would be based on a single actuarial valuation for the cost-sharing plan and the employers collectively, consistent with the benefit-risk-sharing and asset-pooling features of a cost-sharing arrangement, supplemented by an allocation of information produced by that single actuarial valuation to individual employers for their accounting and financial reporting application. Some incremental accounting effort and cost would be required, primarily at the collective-employer (that is, plan) level but also involving individual employers, to allocate (an accounting, rather than actuarial, process), communicate, and apply information measured at the collective level to the accounting and financial reporting of individual employers. However, the Board believes that the benefits of allocating the collective net pension liability, pension expense, and deferred pension outflows (inflows)—including establishing accountability for the net pension liability and fully representing the financial effects of an employer's provision of defined pension benefits through a cost-sharing plan—would exceed the incremental cost. At the same time, the Board believes that the benefit-risk-sharing and asset-pooling characteristics of a cost-sharing plan would be fully and appropriately taken into consideration as long as financial reporting requirements are based on a single actuarial valuation at the collective-employer (plan) level.

# CHAPTER 7—FREQUENCY AND TIMING OF PENSION MEASUREMENTS BY EMPLOYERS

1. This chapter summarizes the Board's preliminary views regarding how frequently an employer's net pension liability should be measured for financial reporting purposes and what the timing of those measurements should be in relation to an employer's fiscal year-end.

## An Employer Should Report Its Net Pension Liability Measured as of Its Fiscal Year-End

2. Because financial statements report the financial position of the government at its fiscal year-end and flows of resources for the reporting period presented, **it is the Board's preliminary view that an employer should report its net pension liability measured as of its fiscal year-end. More specifically, both the total pension liability and plan net assets available for pension benefits should be measured as of the employer's fiscal year-end in conformity with the following requirements:**

- **A comprehensive measurement (an actuarial valuation for accounting and financial reporting purposes) of the total pension liability should be made at least every other year (biennially).**
- A comprehensive measurement of the total pension liability need not be as of an employer's fiscal year-end; however, **the comprehensive measurement used as the basis for determining an employer's net pension liability reported at its fiscal year-end should be as of a date no more than 24 months prior to the employer's fiscal year-end.**
- **If a comprehensive measurement of the total pension liability is not made as of the employer's fiscal year-end, the most recent comprehensive measurement should be updated to that date.** Updated measures should reflect the effects of all significant changes since the most recent comprehensive-measurement date. Professional judgment should be applied to determine the procedures required to reflect the effects of such changes. Determination of the procedures appropriate in the particular facts and circumstances should include consideration of whether a new comprehensive measurement is needed.

3. In reaching its preliminary view, the Board noted that in the absence of cost considerations, an employer could report the net pension liability and resulting pension expense and deferred pension outflows (inflows) based on the results of comprehensive measurements as of the end of each fiscal year. However, the Board is cognizant of cost and other practical concerns related to pension measurement, including the potential cost of obtaining new comprehensive measurements more frequently than currently required, the timely availability of the results of measurements, and potential challenges in obtaining measurements to meet employer reporting requirements in multiple-employer plans in which the employers and the plan have different fiscal year-ends. In light of such concerns, the Board considered several alternatives to a requirement for an employer to have a new comprehensive measurement of its total pension liability as of the end of each

fiscal year. These included less frequent (biennial) measurements, an update approach that would permit in certain circumstances less extensive procedures than those performed as part of a comprehensive measurement, and permitting measurement dates that differ from the employer's fiscal year-end.

## Biennial Comprehensive Measurement of the Total Pension Liability

4. Under the current parameters of Statement 27, comprehensive measurements are required for financial reporting at least every two years. As a means of providing potential cost relief to employers (in comparison to a requirement to obtain comprehensive measurements as of the end of each reporting period), the Board's preliminary view would permit comprehensive measurements of an employer's total pension liability to continue to be obtained biennially.

## Updates of the Total Pension Liability

5. When considering the viability of permitting comprehensive measurements of the employer's total pension liability to be made less frequently than every year, the Board considered what, if any, procedures should be required in periods between comprehensive measurements in order for an employer to have information needed to meet its financial reporting requirements as discussed in Chapters 3–6 of this Preliminary Views. The Board considered the guidance in prior GASB standards, as well as in the pronouncements of other accounting standards setters, and also considered the provisions of Actuarial Standard of Practice No. 4, *Measuring Pension Obligations and Determining Pension Plan Cost or Contributions* (Revised Edition, September 2007), applicable to update procedures. It concluded that for financial reporting purposes, if conditions are relatively stable (for example, if the employer has not experienced significantly higher-than-expected turnover or retirement rates and has enacted no benefit changes), it may be possible to obtain a reasonable estimate of the changes in the total pension liability since the last comprehensive measurement without performing a new comprehensive measurement.

6. The Board acknowledges that if update procedures are used, differences between expected and actual results since the most recent comprehensive measurement date generally would not be reflected in the reported net pension liability, pension expense, or deferred pension outflows (inflows). Those measures would be updated for experience with the next comprehensive measurement. In addition, in a relatively stable environment, there generally would be no reset of demographic or economic assumptions in periods in which an update is used to measure the total pension liability. In such an environment, if adjustments are made at assumed rates for events such as service cost, interest, and benefit payments, it is the Board's view that the reliability of the resulting total pension liability measure may not be significantly adversely affected. The Board also believes that, on the whole, the potential cost savings compared to a requirement for comprehensive measurements as of the end of each reporting period would justify the one-period delay in recognition of differences between expected and actual results.

## Significant Changes

7. Despite the potential for cost savings through the use of update procedures to measure the employer's total pension liability, the Board believes that such an approach would not be suitable if it would not reflect the effects of all significant changes since the date of the prior comprehensive measurement. For example, if significant benefit changes have occurred or if there have been other changes (such as a change in demographics as the result of an early retirement incentive) that, if comprehensively measured, would be expected to significantly affect the employer's net pension liability, pension expense, or deferred pension outflows (inflows), additional procedures, including possibly a new comprehensive measurement, may be necessary to reflect the effects of those events or other transactions. Therefore, the Board's preliminary view would require that consideration be given to the facts and circumstances of each employer at its fiscal year-end to determine the extent of the measurement procedures necessary.

## Measurement Dates That Differ from an Employer's Fiscal Year-End

8. The Board also considered an alternative that would permit an employer to report a measure of its net pension liability determined as of a date that does not coincide with its fiscal year-end. That approach would allow employers in the same plan to use a single measurement date regardless of their fiscal year-ends and potentially would mitigate concerns about the time needed to obtain measures for inclusion in an employer's financial report. However, the Board was concerned that even if the timing of the measurement used by an employer was restricted to a date within its financial reporting period, the net pension liability reported by an employer could be almost an entire year out-of-date. For this reason, the Board concluded that an employer should be permitted to obtain comprehensive measurements of its total pension liability as of a date other than the employer's fiscal year-end in order to provide an opportunity for much of the measurement fieldwork to be done prior to the end of the reporting period, but it also concluded that such measures should be updated to the end of the employer's reporting period.