BEST PRACTICE

Guidelines for Funding Defined Benefit Pensions (2013) (CORBA)

Background. Governments that offer defined benefit pensions to their employees should fund the cost of those benefits in an equitable and sustainable manner. An actuarial valuation provides an employer with crucial information on the amount that needs to be contributed each period to fund the long-term cost of benefits promised to plan participants. Generally accepted accounting principles (GAAP) have required that this actuarially determined amount, known as the *actuarially required contribution* (ARC),[1] be calculated within standardized parameters and disclosed as part of an employer's annual financial report.

Recently, the Governmental Accounting Standards Board (GASB) changed its approach with regard to pension reporting and moved from one that served both the purposes of accounting/financial reporting and funding to one related solely to accounting/financial reporting. As a result, GAAP will no longer require that employers calculate and disclose an ARC in their financial reports starting with fiscal years ending on or after June 30, 2014. Likewise, the parameters (e.g., actuarial cost method, asset smoothing, and amortization) that have standardized how an ARC is calculated have been eliminated from GAAP. In the absence of ARC disclosures, it will be difficult for stakeholders, including policy-makers, employees and the public to determine whether obligations are being appropriately funded. Consequently, there is a pressing need for widely recognized, standardized guidelines as to what constitutes a sound funding plan for a state or local government employer that offers defined benefit pensions. The GFOA and ten other national associations[2] representing state and local governments and retirement systems developed a set of pension funding guidelines to meet this need.[3] The following recommendation is a practical application of those guidelines.

Recommendation. The Government Finance Officers Association (GFOA) recommends that every state and local government that offers defined benefit pensions formally adopt a funding policy that provides reasonable assurance that the cost of those benefits will be funded in an equitable and sustainable manner. Such a funding policy should incorporate each of the following principles and objectives:

1. Every government employer that offers defined benefit pensions should continue to obtain no less than biennially an actuarially determined contribution (ADC) to serve as the basis for its contributions;
2. The ADC should be calculated in a manner that fully funds the long-term costs of promised benefits, while balancing the goals of 1) keeping contributions relatively stable and 2) equitably allocating the costs over the employees' period of active service;
3. Every government employer that offers defined benefit pensions should make a commitment to fund the full amount of the ADC each period. For some government employers, a reasonable transition period will be necessary before this objective can be accomplished;
4. Every government employer that offers defined benefit pensions should demonstrate accountability and transparency by communicating all of the information necessary for assessing the government's progress toward meeting its pension funding objectives.

The GFOA intends to develop additional best practices that will provide specific guidance on the practical application of these principles and objectives to each of the three core elements of a comprehensive pension funding policy: actuarial cost method, asset smoothing, and amortization.

Notes

[1]The new GASB standards no longer use the term "annual required contribution," or (ARC). Instead, the new standards refer to the disclosure of an "actuarially determined contribution" (ADC).

[2] The other ten national organizations include: National Governors Association, National Conference of State Legislatures, Council of State Governments, National Association of Counties, National League of Cities, U.S. Conference of Mayors, International City/County Management Association), the National Association of State Auditors, Comptrollers and Treasurers, the National Association of State Retirement Administrators, and the National Council on Teacher Retirement. The Center for State and Local Government Excellence is convening this task force.

[3] The GFOA Executive Board passed a resolution expressing the GFOA's support for the pension funding guidelines developed by the GFOA and nine other national associations. The resolution can be found at: http://www.gfoa.org/index.php?option=com_content&task=view&id=2539

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