



PERiSCOPE

Public Employee Retirement Systems

New accounting rules for public pension plans in the United States are set to take effect beginning in 2014. Successful implementation of the new rules will require an understanding of a variety of technical concepts regarding the various newly required calculations. In this multi-part PERiScope series, we explore these technical topics in detail. See sidebar for more information on upcoming technical articles in this series.

GASB 67/68: Substantively automatic plan provisions

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This *PERiScope* article in the GASB 67/68 miniseries discusses “substantively automatic” plan provisions and their inclusion in the determination of a plan’s *total pension liability* (TPL). For many plans, the concept of “substantively automatic” is critical to the treatment of cost of living adjustments (COLAs), which are often granted on a discretionary or ad hoc basis.

Background: New GASB Standards

When measuring future benefits and liabilities for purposes of GASB 67/68 reporting, actuaries are required to incorporate automatic postemployment benefit changes, including automatic COLAs, into their projections. A COLA would be considered “automatic” if it is required by contract, statute or is an otherwise binding plan provision.

Many public retirement systems provide inflationary adjustments for retirees in addition to—or in place of—any automatic COLAs. These types of adjustments are usually granted at the discretion of the governing body and are often referred to as “ad hoc COLAs.” According to GASB 67/68, ad hoc COLAs are required to be incorporated in actuarial calculations if such COLAs are deemed to be “substantively automatic.”

In Statements 67 and 68, GASB neither objectively nor specifically defines the term “substantively automatic” and it does not prescribe a one-size-fits-all formula for determining if a plan’s COLA policies fall into this category. GASB does provide a non-exhaustive list of relevant factors. These will be presented later in this article, but at this point it may be helpful to consider a simple example.

Example: Automatic and Ad Hoc COLA

Consider a plan in which retirees are guaranteed to receive a 2% COLA each year. Along with this guaranteed increase, retirees may also be granted an additional COLA, which would keep benefits

Did you know? Milliman’s GASB 67/68 Task Force is releasing a miniseries on technical and implementation issues surrounding GASB 67 and 68. Each article will be released through *PERiScope*. Several articles have been published, with more articles to be published shortly. Look for the following articles in coming months:

- Balance sheet items and projections from valuation dates to measurement dates
- Calculation of pension expense
- Proportionate share calculations
- Special funding situations

Additionally, a Frequently Asked Questions document will be maintained, with links to relevant miniseries articles as they become available.

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growing with inflation (which is often higher than 2% per year), but which is not guaranteed. The decision is made by the plan's governing body on whether or not the retirees receive the additional increase in any given year.

Assuming for simplicity that long-term inflation is 3%, it is possible that retirees would receive a 3% increase each year. However, while the first 2% is guaranteed by the plan provisions, the additional 1% is not. The governing body has the final authority with respect to the extra 1% each year, and bases its annual decision on a number of factors such as the plan's funded status, post-valuation investment performance, and the cost of providing the additional COLA.

The question raised by GASB 67/68 is: Should the actuary perform GASB 67/68 calculations reflecting a 2% COLA, a 3% COLA, or somewhere in between? The answer depends on whether the additional 1% increase—or any portion of it—is deemed to be substantively automatic.

Where Does Your Plan Stand?

Whether or not an ad hoc COLA is substantively automatic will need to be determined for each plan on a case-by-case basis. GASB 67 does provide a list of some of the factors to consider in this determination:

- The plan's historical pattern of granting (or denying) ad hoc COLAs
- Consistency in the amount of the COLAs, or the amounts relative to a pre-determined inflation index (e.g., the Consumer Price Index)
- Whether there is evidence indicating that the ad hoc COLAs will *not* be granted in future years

This is by no means an exclusive or exhaustive list. There are plenty of other key considerations, including:

- The plan's stated policies and goals
- Public statements by the plan's governing body, both oral and written
- Expectations of plan members
- The political environment of the state, county, or municipality served by the plan

What More Do the GASB Statements Say?

According to GASB 68, "the ad hoc [COLA] would have to be considered part of the pension plan terms associated with the employment exchange" to be substantively automatic. The statement notes that if the employer does not provide the COLA, yet is obligated to give something approximately equivalent in exchange, (e.g., a salary increase or some other form of compensation) then a COLA is substantively automatic.

GASB 68 further states, "The definition of a liability...includes a notion...under which the definition of a liability would be met not because payment of the liability is legally enforceable but because of circumstances that leave the government little or no discretion to avoid paying the liability." Again there is a reference to "circumstances," indicating that each plan's COLA provisions need to be evaluated on a case-by-case basis.

The phrase "little or no discretion" is also critical; it is used multiple times in the statement's discussion of substantively automatic plan changes. The concept of substantively automatic rests largely on whether there is true discretion to grant or deny an ad hoc COLA. If such discretion exists, who yields it? Can a governing body be overruled? Do a plan's practices and circumstances indicate that an ad hoc provision is discretionary in name only?

As mentioned, history and consistency are both relevant factors. GASB 68 does caveat this by saying, "Evaluation of current and expected future environments speaks to whether there is evidence to conclude that changes might not continue to be granted in the future, despite what might otherwise be a [historical] pattern that would suggest such changes are substantively automatic." Once again, any such "evidence" would be identified within a plan's specific situation. A new collective bargaining agreement, new legislation, or a change in plan governance might all be indicators that future experience will differ from past history.

In short, the statements call for certain criteria or thresholds to be applied to the facts and circumstances of each individual plan:

- Is there little or no discretion to grant or deny the COLA?
- Is the COLA considered part of the plan terms or the employment exchange?
- Is there a historical pattern? Is there any evidence that the pattern has changed or will change?

GASB's language suggests that ad hoc COLAs are not substantively automatic unless these criteria are met.

The plan sponsors have ultimate authority over their financial statements. Policies and procedures regarding any ad hoc COLA should be reviewed to determine if it meets the criteria for being substantively automatic. Any decision should be evaluated by the plan's auditors.

No matter how an ad hoc COLA is ultimately treated in the actuarial calculations, the conclusion regarding whether or not a benefit increase is deemed substantively automatic should be disclosed in the final report or in the corresponding GASB 67/68 footnotes. Along with this disclosure, the report should provide an explanation as to why an ad hoc COLA is or is not treated as substantively automatic.

Conclusion

It is common practice for public pension plans to provide cost of living adjustments for their retired members, but every plan differs in how COLA provisions are incorporated into the governing documents. Countless methods and formulas exist; many COLAs are automatic or collectively bargained years in advance.

In contrast, many other plans maintain a degree of flexibility regarding their COLAs. By invoking the substantively automatic concept, GASB has required that a determination be made: Are the plan provisions in question automatic for all practical intents and purposes, or does the governing body apply such provisions at its discretion? Careful consideration should be given to this question. Just as salary projections and assumed investment returns have a significant impact on a plan's reported liabilities, so too will the inclusion (or exclusion) of future benefit increases.

Please note that although COLA provisions may or may not be required to be included in GASB 67/68 calculations, it does not need to impact the funding of any COLA provisions. The liabilities determined under GASB 67/68 may differ from the liabilities determined for funding for a variety reasons and the treatment of COLA provisions may be another source of this difference.

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