GFOA Best Practice

Funding Defined Benefit Pensions

Background. Compensation packages for active workers may include health-care and other similar benefits for employees who have completed their active service. Generically, these benefits are described as other postemployment benefits (OPEB) to distinguish them from pensions.[1] Employers are required to recognize the cost of pension benefits as employees earn them, and the Governmental Accounting Standards Board (GASB) has now extended this same requirement to OPEB.[2] The change in accounting standards has focused attention on the costs of OPEB as never before, including concerns about rising health-care costs and an aging public-sector workforce. The real issue is not the new accounting for OPEB, as such, but rather the underlying budgetary and funding challenge that those accounting standards highlight. Meeting this challenge will require government finance officers to ensure that these benefits are sustainable over the long term - that they are affordable to stakeholders, competitive, and sufficient to meet employee needs, and that they may be reasonably expected to remain so.

Recommendation. 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.

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] Some government employers choose to augment other elements of employee compensation rather than providing OPEB.

[2] See GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The Financial Accounting Standards Board (FASB) has required the same of private-sector employers since the implementation of FASB Statement No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, which was released in 1990.

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