

Bond Case Briefs

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GASB - Postemployment Benefits: Determining the Long-Term Expected Rate of Return.

Calculating an appropriate discount rate to measure the net liability for postemployment benefits is a critical financial accounting and reporting issue for state and local governments. The *long-term expected rate of return* is a fundamental component used in developing the discount rate. As can be seen by the sensitivity disclosures required by the postemployment benefits standards, a change of just 1 percentage point in the discount rate can have for many plans a significant impact on the net liability.

In justifying the *long-term expected rate of return*, one often hears “historical investment performance supports that rate.” The standards, however, address the *long-term **expected** rate of return*. Historical data can be inconsistent with the forward-looking nature of this expectation and is not a complete source for the development of long-term anticipations about future economic phenomena.

The *long-term expected rate of return* should be based upon the nature and mix of current and expected postemployment benefit investments. That means the postemployment benefit investments must be expected to be invested using a strategy to achieve that return.

During the development of the postemployment benefits standards the Board concluded that it was not within the scope of the Board’s activities to set standards that establish a specific **funding** method for postemployment benefits—that is a policy decision for government officials or other responsible authorities to make. Accordingly, the postemployment benefits standards set requirements in the context of **accounting, not funding**. This is a very important distinction, as one also often hears “we will reduce the discount rate gradually over time, that’s all we can afford now.” Affordability is a **funding** issue, **not** an **accounting** issue.

The **accounting** standards require the use of the *long-term expected rate of return* to develop the discount rate—**funding** affordability is **not** a component to be considered in determining the *long-term expected rate of return* when developing the discount rate for financial accounting and reporting purposes. To appropriately comply with the postemployment benefits standards for financial reporting purposes, it is critical that governments measure the net liability for postemployment benefits using a discount rate based on an **accounting** perspective—one that appropriately incorporates the *long-term expected rate of return*—**not** a rate based on a **funding** affordability perspective.

FROM THE CHAIRMAN
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