PacificCPE

COURSE

211510A

Pension Plans and Fiduciary Activities in Government Accounting

Pensions represent one of the most significant and complex liabilities facing governments today. This course covers how governmental entities account for defined benefit and defined contribution pension plans under GASB standards, along with other fiduciary activities and trust fund reporting. It also explores the ongoing debate about whether defined benefit plans can survive fiscal pressures. Professionals who advise public sector clients or audit governmental retirement systems will find this course directly relevant to their work.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

Start Course ↓

Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the factors involved in calculating pensions and how to properly account for them.

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Publication Date: February 2026

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Chapter 1: PENSIONS AND OTHER FIDUCIARY ACTIVITIES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the factors involved in calculating pensions and how to properly account for them.

This chapter deals first with one of the most significant and controversial issues facing governments from both accounting and policy perspectives: how to deal with employee pensions and other postemployment benefits. It then addresses issues of fiduciary and related activities. Although it is natural to think of the assets of governments or not-for-profits as being mainly highways, buildings, police cars, research laboratories, and the like, in fact, governments and not-for-profits represent some of the nation's largest holders of stocks, bonds, and similar securities. These assets are often concentrated in pension and other fiduciary funds.

WHY IS PENSION ACCOUNTING SO IMPORTANT?

The accounting for pensions is, and no doubt will continue to be for many years to come, among the most important, yet controversial, issues of our era. The accounting for pensions would be important for no other reason than the magnitude of the assets and liabilities involved. The assets of state and local government pension funds are huge. For example, as of late 2024, CalPERS, the California Public Employees' Retirement System, had over $530 billion of assets; CalSTRS, the California State Teachers' Retirement System, had over $356 billion. Comparable large obligations are a cause of major *budgetary* strain for many governments. The significance of pension accounting goes beyond the numbers; it has a direct impact on public policy. Conservative political groups that favor decreased government spending and believe that the retirement plans of government employees are overly generous promote accounting standards that increase the reported liabilities of pension plans. They believe that if the plans were required to present their fiscal status in a more conservative light, the public would pressure their elected officials to modify the plans and reduce employee compensation. Understandably, liberals, and of course, employee unions take an opposite position, favoring accounting rules that minimize the reported liabilities and put the most favorable fiscal shine on the plans. The road to governmental fiscal failure has long been paved with inadequately funded pensions. In the years following World War II, New York City substantially expanded its workforce. In exchange for smaller increases in direct wages and salaries, the city offered some groups of employees exceedingly generous retirement benefits. In the subsequent years, the city failed to contribute adequately to its pension funds, sometimes basing its contributions on outmoded actuarial tables. By the mid-1970s, when many of the employees hired

after the war reached retirement age, the required pension outlays consumed such a large portion of the city's current budget that they were a major cause of its fiscal crisis and the city's resultant forced reorganization. In more recent years, the bankruptcies of Detroit, Stockton (California), and Central Falls (Rhode Island) can be tied directly to inadequately funded pension plans. So, too, can the current fiscal tribulations of New Jersey, Illinois, and Connecticut. But the problems of these governments are hardly uncommon. Government officials are far more willing to grant benefits that will have to be paid for many years in the future—when they will no longer be in office—than they are to offer current wage and salary increases[1]. As noted in the accompanying "In Practice," the pension plans of many state and local governments continue to be severely underfunded and threaten the fiscal sustainability of numerous local and well as state governments.

In Practice: Best and Worst Funded State Pensions Systems as of 2023 (Including Washington, DC)

Rank	State	Funded Ratio	Unfunded Liability (in Millions)
1	Washington, DC	107.2%	$728.5
2	Utah	107.0%	−3,272.1
3	Tennessee	105.0%	3,197.8
4	Washington	103.5%	−5,050.6
5	Wisconsin	100.2%	−255.3
:			
47	South Carolina	59.9%	27,221.5
48	Connecticut	57.8%	37,287.2
49	New Jersey	53.5%	95,228.6
50	Illinois	50.9%	208,012.0
51	Kentucky	50.1%	40,548.8

Source: From website of Equable, https://equable.org/pension-plan-funded-ratio-rankings-2023/.

A pension is a sum of money typically paid over time to retired or disabled employees based on their years of employment. Although employees earn their pensions—and their employers benefit from their services—during their years of employment, the actual cash payments do not have to be

made to the employees until their years of retirement. Thus, the benefits received and the cash payments may be mismatched by many years. As will be evident from our discussion of pensions, the difficult accounting issues arise because, depending on the type of plan, (a) the amount of the eventual cash payments to the employees may depend on variables that are unknown at the time the employees provide their services, and (b) it is not obvious how the eventual costs of the benefits should be allocated to the particular years in which the employees provide their services. The accounting issues pertaining to **other postemployment benefits (OPEB)**, mainly retiree health insurance, are closely tied to those of pensions. As is discussed later in this chapter, these other types of benefits have economic characteristics similar to those of pensions and though less publicized may be no less of a threat to governments' fiscal well-being. These benefits are addressed later in this chapter.

HOW DO DEFINED CONTRIBUTION PLANS DIFFER FROM DEFINED BENEFIT PLANS?

Defined Contribution Plans

Employers maintain two types of pension plans. The first, and by far the simpler to account for, is a **defined contribution plan**. Under a defined contribution plan, an employer agrees to make a series of **pension contributions** to a pension fund. A separate account is maintained for each employee. Typically, the amount is expressed as a percentage of each employee's salary, and very often the pension fund is totally independent of the employer. For example, a college may contribute 8 percent of a faculty member's salary to TIAA (Teachers Insurance and Annuity Association), provided that the faculty member also contributes a corresponding percentage. TIAA invests the contributions, and upon retirement, the employee can begin to withdraw the funds, plus accumulated investment earnings. The actual benefits to be received by the employee depend on the fund's investment performance. The employee bears all the investment risks. If the investment portfolio does well, the employee reaps the benefits. If it does poorly, it is the employee who will have to cut back on his or her anticipated retirement lifestyle. As implied by the plan's name, the employer defines (specifies) the inputs—its contributions. It makes no guarantees as to the outputs—the payments to be made to its employees when they retire. Defined contribution plans present few financial or accounting complexities for the employer. The employer reports an annual expense for the amount that it is obligated to contribute to the pension fund. As a result, the plan has no unfunded actuarial liabilities. Governmental Accounting Standards Board (GASB) standards require note disclosures that include a description of the plan and the benefits provided. In addition, to the extent that the employer makes the contributions to a fiduciary fund that it controls itself (as some employers do), it must also provide details about the investments that it holds. Although most municipalities maintain defined benefit plans, many also have established defined contribution plans for certain of their employees.

Defined Benefit Plans

This chapter is concerned mainly with the type of plan that is more common in government—and more difficult to account for—the **defined benefit pension plan.** Under a defined benefit plan, the employer specifies the benefits—the actual pension payments—that the employee will receive upon retirement. Usually, the benefits will vary according to length of service and salary. For example, a college might promise to pay faculty members 2.5 percent of their average annual salaries during their final three years of service for each year of employment. Faculty members with 30 years of service who earned an average of $100,000 during the three years prior to retirement would be guaranteed an annual pension of $75,000 (2.5 percent × 30 years × $100,000). In contrast to the defined contribution plan, the employer guarantees the outputs (payments to the retirees), not the inputs (contributions to the pension fund). It is therefore up to the employer to ensure that it sets aside sufficient resources each year to make the required payments. Both funding and accounting decisions relating to defined benefit plans are complex, mainly because of the uncertainties about the amounts that will have to be paid to the retirees and that will be earned on fund investments. Sound financial policy and the need to report on interperiod equity dictate that the costs of pensions be allocated to the periods in which employees perform their services and earn their pension benefits—not those in which they receive the cash benefits. However, the actual cost cannot be known for certain until the employees receive all the benefits that they have been promised. These will not be known until the employees (and sometimes their spouses, if they are also entitled to benefits) have died. The key uncertainties affecting the actual cost of a defined benefit pension plan include:

- Employee life expectancy
- Employee turnover rates (employees usually must accumulate a specified number of work years before qualifying for even minimum benefits and must satisfy other conditions relating to length of employment and age to qualify for full benefits)
- Future wage and salary rates
- The investment returns on pension fund assets

The amount that an employer must provide each year to meet its future pension obligations can be calculated actuarially. Actuaries are statisticians who compute insurance risks and premiums.

In the private sector, almost all companies and not-for-profit organizations that launch new pension plans now establish defined contribution plans as opposed to defined benefit plans, and many firms that previously had defined benefit plans are converting them into defined contribution plans. The reasons are multiple. Defined contribution plans are more portable; that is, they permit employees to change jobs without losing any of the funds that their retirement account has accumulated. They are less subject to federal regulation, in particular the Employee Retirement Income Security Act of 1974 (ERISA). They present less risk to the employer; once it has made its contributions to the designated fund, it bears no investment or actuarial risks. Most saliently from an accounting

perspective, once the employer has made its required contribution, it does not have to report any pension-related liabilities on its balance sheet.

In Practice: Defined Benefit Plans Are More Efficient Than Defined Contribution Plans

In state and local governments, defined benefit plans are still dominant, covering about 90 percent of current employees. However, because the pension plans of so many governments are severely underfunded—and are thereby a threat to the governments'fiscal sustainability—there is considerable pressure on them to convert to defined contribution plans. This pressure, however, is ironic. Most actuaries contend that defined benefit plans are more efficient than defined contribution plans. Dollar for dollar of contribution, they provide the greater benefit. In large part, this is because in defined contribution plans resources are assigned to individual employees. Employees are entitled only to what has been accumulated in their individual accounts. Employees, therefore, bear not only investment risks but also that of their mortality. Thus, to be safe, employees must assume that they will have the good fortune to live for perhaps 30 or even 35 years beyond the customary retirement age of 65. That good fortune, however, may result in fiscal disaster if they outlive the resources in their plans. By contrast, in defined benefit plans, the risks are pooled and thereby spread among all members of the plan. Statistically, therefore, the average life expectancy of the employee pool may be no greater than 17 years beyond retirement. Hence, fewer dollars, in total, need to be put into a defined benefit plan than into a defined contribution plan.

In addition, because the resources of all employees are mingled in a single investment fund, investment yields of defined benefit plans may be greater than those of defined contribution plans. Sound retirement planning suggests that as employees age and approach their retirement, they should generally move to increasingly conservative investment portfolios (e.g., those with an increasing proportion of fixed income securities, such as bonds, as opposed to stocks). That is because if stock prices take a tumble, there is less time for them to recover. Typically, more conservative—less risky—investments provide lower returns. In a defined contribution plan as individual employees get older, they must move to more conservative, lower-yielding, investments. In a defined benefit plan, however, the population includes young employees as well as retirees and employees approaching retirement. New, young employees join the plan and replace older ones. Therefore, the average age of the members of the plan may remain relatively constant, and it need not move, over time, to the more conservative, lower-yielding, portfolio.

In Practice: Can Defined Benefit Plans Be Saved?

In light of the fiscal stress that underfunded pension plans are placing on state and local governments, the need for reform is widely acknowledged. As noted in the text, some critics of defined benefit plans contend that governments should convert these plans to defined contribution plans. But, if, as many actuaries maintain, defined benefit plans are more efficient than defined contribution plans, then any cost savings for government employers will result in reduced benefits for their employees. Are there other reforms that governments should consider short of shifting to defined contribution plans? Here are some possibilities:

- *Eliminate "spiking."* Many plans base benefits on compensation earned in the last year of employment. To increase their compensation and thereby enhance their benefits, some employees work extra hours of overtime in their final year of employment. They, thereby, manage to earn more in retirement than in a typical year of employment. To eliminate spiking, pension benefits should be based on some long-term average (e.g., the final three years) of compensation and exclude overtime hours.
- *Reduce opportunities for "early" retirement.* Governments typically provide for full retirement benefits after as few as 20 years of service. Thus, employees who began their careers at age 25 are able to collect pensions at age 45. Although relatively early-age retirement may be appropriate for some city workers, such as police officers and firefighters, it is clearly inappropriate for others.
- *Increase the age at which benefits can be collected.* In some governments, pensions can be collected as soon as employees retire. Thus, if employees retire from government at age 50, but then take other jobs, they still collect their government pensions. Pension plans could be structured so that benefits do not begin until an employee reaches a "normal" retirement age, perhaps 65.

In arguing for pension reform, it is often pointed out that retirement benefits for government employees are more generous than for those in the private sector. Whereas that may be correct, it should also be noted that retirement benefits are only one form of compensation. In comparing compensation of government employees to those in the private sector, all forms of compensation must be taken into account. To be sure, some government employees, especially those in unskilled positions, earn more than their private-sector counterparts. Others, notably in high-level positions, do not. This was vividly illustrated in a class taught by one of the course's authors. He asked a student, who was serving in the army, how much the general who was in charge of the U.S. war in Iraq earned each year. His response was, "I'm not certain, but it is most definitely less than that of his translator, who is an employee of a private contractor."

What Are the Distinctions Among Single, Agent Multiple-Employer, and Cost-Sharing Plans?

Assets that have been set aside for pensions per a defined benefit plan are generally *legally restricted* and are held for the benefit of employees. Therefore, they are accounted for in a trust (fiduciary) fund. Government pension trusts that are *organizational*ly separate from their sponsoring governments are often referred to as **Public Employee Retirement Systems (PERS).** Some pension plans are established by a single employer and cover only the employer's own employees. These are referred to as **single (or sole) employer plans**. Others are established by a sponsoring organization, such as a state or a county, for employees of governments within its jurisdiction. Under one type of multiple-employer plan (an agent **multiple-employer plan**), the invested assets are pooled. However, separate **accounts are maintained and actuarial computations are made for each** employer. In substance, therefore, each employer has its own single-employer plan; the sponsoring agent merely provides administrative and investment services. Thus, the accounting for agent multiple-employer plans is, in essence, the same as for single employer plans. Under another type of multiple-employer plan, a **cost-sharing multiple-employer plan**, not only are the assets pooled for investment purposes, but the benefits for all employees of all participating governments are paid for from the common pool. Actuarial calculations are made for the plan as a whole, not for the individual participating employers. The employers share all risks and costs and make contributions at the same rate.

WHAT IS THE RELATIONSHIP BETWEEN AN EMPLOYER AND ITS PENSION PLAN?

A pension plan (also referred to as a pension fund) is an arrangement in which the pension investments are held and managed. Commonly, but not always, the pension plan takes the form of a trust fund in which the trust assets are *legally separate* from those of its sponsoring employer. However, whether maintained by the employer itself or an outside party, the plan is an independent financial and accounting entity. If maintained by the employer, then the employer must include the plan in its financial statements just as it does its other fiduciary funds. If the plan is maintained by an outside party, then the employer must disclose information about its financial condition in notes to its financial statements.

The assets of a pension plan consist mainly of cash, securities, and other income-producing assets. Its economic obligations (irrespective of whether and when they are given accounting recognition) are the pension benefits that have been earned by its plan members—both employees already retired and those currently in the workforce.

Even though pension plans are independent fiscal and accounting entities, they are inexorably linked to their sponsoring employers and the individual funds from which the pension contributions will be received. Under a defined benefit plan, an employer is ultimately liable for the benefits to be paid to retirees. Therefore, the obligations of the plan are, in economic substance, those of the employer. Similarly, if the plan assets increase or decrease in value, the ultimate benefits or costs revert to the employer in that its future contributions can be greater or less.