

GRS INSIGHT

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The GASB's Exposure Drafts on Pension Accounting and Financial Reporting

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In This Issue

The GASB's Exposure Drafts set out proposed changes in pension accounting and financial reporting standards for state and local government employers and plans that provide pension benefits.

Exposure Drafts are usually the last public documents that the GASB issues before issuing the final statements, and so provide one last opportunity for public comment.

The GASB is requesting comments on the Exposure Drafts by September 30, 2011, and will hold public hearings in October. It is important for stakeholders to review the proposed changes, consider their impact, and provide comments.

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On July 8, 2011, the Governmental Accounting Standards Board (GASB) issued two Exposure Drafts (EDs) on proposed changes to pension accounting and financial reporting standards for state and local governments. The first, *Accounting and Financial Reporting for Pensions* (amending GASB Statement No. 27), details proposed standards that would apply to certain financial statements of governments that provide pension benefits. The second, *Financial Reporting for Pension Plans* (amending GASB Statement No. 25), details proposed standards for the financial statements of plans that administer the benefits. Readers should note that all of the GASB's decisions are considered tentative until approved as final. In addition, while the GASB's authority extends to accounting and financial reporting, it does not extend to the actuarial valuations performed for funding purposes.

The EDs are being issued after a lengthy deliberative process that included the issuance of an Invitation to Comment in 2009 and a Preliminary Views document in 2010. If adopted, the EDs would significantly change pension accounting and financial reporting for state and local governments by:

- Disconnecting state and local governmental pension accounting measures from the funding measures used to determine pension contributions;
- Requiring employers to recognize an unfunded pension obligation (i.e., the "net pension liability") as a balance sheet liability in their basic financial statements based on the market value of assets;
- Requiring employers to recognize a new measure of the pension expense in their basic financial statements that may have no relation to the actuarially determined contribution; and
- Replacing most of the current note disclosures and required supplementary information with information based on the new measures and removing disclosures showing the actuarial funded status of the benefits.

This article focuses on the GASB's proposed changes. However, to present the changes in context, the article begins by providing background on state and local government pensions and summarizing the GASB's current pension standards.

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Single, Agent and Cost-Sharing Employers

A key distinction that the GASB makes in both the current and proposed standards is the distinction between single employers, agent employers and cost-sharing employers. As defined by the GASB:

- A “single employer plan” is a defined benefit pension plan used to provide pensions to employees of only one employer. The employer in such a plan is referred to as a “single employer.”
- An “agent multiple-employer plan” is a defined benefit pension plan that pools the assets of multiple employers for investment purposes, but each employer’s share of the pooled assets is legally available to pay pensions for only that employer’s employees. Employers participating in such plans are referred to as “agent employers.”
- A “cost-sharing multiple-employer plan” is a defined benefit pension plan that pools the assets and obligations of multiple employers and can use the assets to pay the pensions of any of the employers’ employees. Employers in these plans are referred to as “cost-sharing employers.”

These distinctions are important since, in both the current and proposed GASB standards, single and agent employers are subject to different pension accounting standards than cost-sharing employers.

Qualified Trusts or Equivalent Arrangements

Generally, state and local government pension benefits are provided through trusts or other arrangements that (1) receive actuarially determined contributions from employers, (2) invest the assets and contributions, and (3) pay benefits from the accumulated assets and investment earnings. The trusts are used to protect the assets and hold them for the exclusive benefit of the covered members.

Although trusts are formal legal arrangements, they have not been specifically defined in the accounting standards for state and local government pensions.² In the new EDs, the proposed standards would apply to defined benefit pensions or defined contribution pensions that are administered by “qualified trusts, or equivalent arrangements.” Borrowing from its work in GASB Statement No. 45, the GASB defines such arrangements as those in which:

- Employer contributions to the plan and investment earnings are irrevocable;
- Plan assets are dedicated to providing pensions to plan members in accordance with plan terms;

- Plan assets are legally protected from the creditors of: (1) the employer, (2) nonemployer entities that contribute to the plan, or (3) the plan administrator. In addition, to meet the GASB’s definition, assets would also have to be protected from the creditors of plan members.³

Apparently, to the extent pension benefits are not provided through qualified trusts, the GASB’s proposed standards would not apply. Plan documents and state law should be consulted to determine if the plan constitutes a qualified trust or similar arrangement. Future guidance is expected from the GASB for pension funds that do not satisfy the conditions for a qualified trust or similar arrangement.

Defined Benefit Pensions

Most of the GASB’s proposed changes apply to “defined benefit” (DB) pensions, i.e., pensions for which income and other benefits are defined by the benefit terms, including those stated as a specific dollar amount or as amounts based on age, years of service, or compensation. The GASB distinguishes DB pensions from “defined contribution” (DC) programs, which: (1) provide an individual account for each employee, (2) define the required employer contributions, and (3) provide that the employee’s benefit depends only on the amounts accumulated in the employee’s individual account (with adjustments for forfeitures and administrative costs).⁴ While the EDs include proposed standards for DC pensions, they are essentially the same as the current standards.

The GASB also distinguishes DB pensions from other post-employment retirement benefits (OPEBs), including retiree health care. To the extent the DB pension plan provides postemployment benefits other than retirement income (such as death benefits, life insurance and disability benefits), they would be considered DB pension benefits under the proposed standards.

However, such benefits provided outside of the DB pension plan, or any retiree health care benefits, would not be subject to the proposed pension standards. Instead, they would be subject to the current OPEB standards. (Note that the GASB has begun to review the OPEB standards and may propose changes that are similar to those provided in the pension EDs.)

The GASB’s Current Standards for DB Pensions

Generally speaking, accounting and reporting standards establish how financial items are defined and measured (e.g., what constitutes an “expense” or a “liability”) and where the items are displayed in the government’s financial report (e.g., the basic financial statements, notes to the financial

² However, qualified trusts are defined in the GASB’s accounting standards for “other postemployment benefits” (OPEBs).

³ *Accounting and Financial Reporting for Pensions*, paragraph 4.

⁴ *Accounting and Financial Reporting for Pensions*, paragraph 8.

statements, or other sections of the financial report). Items recognized in the basic financial statements (e.g., the balance sheet and operating statement) are seen as having greater weight than those disclosed in the notes to the financial statements or in required supplementary information.

Current Standards for Single and Agent Employers

The GASB's current standards set constraints on the actuarial methods and assumptions that may be used for accounting and reporting purposes, which include requiring:

- One of six approved actuarial cost methods be used to determine pension costs and liabilities. For the most part, these methods include the projection of salary and certain other factors in determining the normal cost of benefits;⁵
- The long-term expected rate of investment return be used to project future investment earnings and to discount the present value of future benefits; and
- The period for amortizing unfunded actuarial liabilities be limited to 30 years.

The current standards also allow the actuarial value of assets to reflect investment gains and losses that are averaged over time to smooth the impact of investment volatility on funded levels and contribution rates.

Under current standards, pension accounting measures are closely related to pension funding measures. For single and agent employers, the employer's "pension expense" is the "annual pension cost" (APC) determined using the same actuarial methods and assumptions used to determine the contributions necessary to fund the plan.⁶ It may or may not equal the actual employer contribution made to the plan, depending on the actual funding policy in place. In any event, the APC would usually be a reasonable and actuarially-based funding amount.

The APC consists of the employer's "annual required contribution" (ARC) plus certain adjustments if the employer has contributed more or less than the ARC over time. The ARC, in turn, is the actuarially determined cost of the benefits allocated to a given year (i.e., the "normal cost" or "service cost") plus the amortization of any unfunded actuarial accrued liabilities.

⁵ The six actuarial cost methods are entry age, frozen entry age, attained age, frozen attained age, projected unit credit, and aggregate. A seventh method, the unit credit cost method, is only acceptable for plans in which accumulated benefits are not affected by future salary levels, since this method does not include projections of either salary or service.

⁶ GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*.

Also under current standards, a single or agent employer's balance sheet liability for pensions is the "net pension obligation" (NPO). It is calculated as the accumulated difference between the employer's annual pension cost and the employer's actual contributions to the plan since the effective date of GASB Statement No. 27 (i.e., for reporting periods beginning after June 15, 1997).

Current Standards for Cost-Sharing Employers

For cost-sharing employers, the current measure of pension expense is the employer's contractually required contributions to the plan, which may or may not be actuarially determined. The cost-sharing employer's balance sheet liability is the accumulated difference between the employer's contractually required contributions and the employer's actual contributions. Since the vast majority of cost-sharing employers pay their contractually required contributions, their current pension liabilities are generally zero (whether or not the employer's contractually required contribution was actuarially determined to fund the plan).

Disclosures and Required Supplementary Information

The current standards also require employers to disclose information about pension benefits in the notes to the financial statements and in other sections of the employer's financial report. Generally, these disclosures include, but are not limited to a description of the plan, annual required contributions and actual contributions. In addition, single employers and agent employers must also disclose: the actuarial value of plan assets, actuarial accrued liability, unfunded actuarial accrued liability, funded status, and related actuarial methods and assumptions.

The GASB's New Framework

As a result of its deliberations, the GASB applied its new conceptual framework to pension accounting and reporting. While the current standards are based on the employer's funding costs of providing pension benefits (i.e., the annual required contributions), the new proposed standards are based more on the GASB's view of the employer's pension liability. Several of the GASB's underlying concepts include:

- The employer incurs a pension obligation as a result of the exchange of employee services for compensation (referred to as the "employment exchange");
- The employment exchange should be viewed as an ongoing, career-long relationship;
- The pension plan is primarily responsible for paying pension benefits to the extent it has sufficient assets;

- The employer is primarily responsible for paying benefits to the extent the plan does not have sufficient assets; and
- The unfunded pension obligation meets the definition of liability under GASB Concepts Statement No. 4 and is measurable with sufficient reliability to be recognized in the basic financial statements.

The Net Pension Liability

Based on the new concepts, the GASB decided that the employer's basic financial statement liability for pension benefits should be a measure of the employer's unfunded pension obligation. Referred to as the "net pension liability" (NPL), it would be calculated as the employer's "total pension liability" (TPL) minus the employer's "plan net position" (PNP). Plan net position is essentially the fair (market) value of plan assets at the end of the employer's fiscal year.

The total pension liability is calculated by:

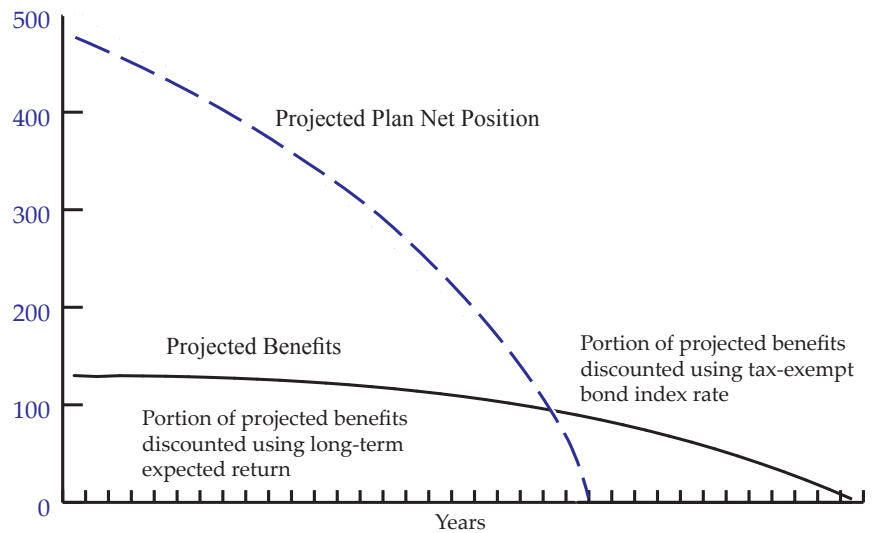
- Projecting future benefits arising from automatic COLAs (and ad hoc COLAs, to the extent they are substantively automatic⁷), as well as projected service and projected salaries;
- Discounting the present value of future benefits using a single discount rate (discussed further in the next section); and
- Allocating the cost of pension benefits over past, present, and future periods using the traditional entry age actuarial cost method with service costs determined as a level percent of projected payroll on an employee-by-employee basis.

The Single Discount Rate

Under the proposed standards the discount rate would be a single rate based on: (1) the long-term expected investment return to the extent current and expected future assets are sufficient to pay projected benefits, otherwise (2) a 30-year AA/Aa tax-exempt municipal bond index rate. Chart 1 may be helpful in illustrating the process for determining the proposed new single discount rate. (Note that the graph is intended as an illustration and does not represent an actual pension plan.)

⁷ In determining whether or not an ad hoc COLA is substantively automatic, the GASB suggests examining (1) the historical pattern of granting the COLAs, (2) consistency in the COLA amounts, and (3) whether there is evidence to conclude the COLAs might not be granted in the future.

Chart 1: Illustrative Projected Benefits and Projected Plan Net Position



In Chart 1, the solid line shows the benefits that are projected to be paid to current pension plan members (employees and retirees) over time. The dashed line shows the current market value of plan assets plus projected future contributions and investment earnings – minus benefits paid to current members. Note that plan assets become insufficient to pay current projected benefits after about 22 years (i.e., the cross-over point).

To determine the GASB's proposed discount rate for a plan with a cross-over point as illustrated in Chart 1, we would start by calculating two present values: (1) the present value of benefits up to the cross-over point would be discounted using the long-term expected return on plan investments (since these benefits would be covered by projected assets); and (2) the present value of the benefits after the cross-over point would be discounted using a 30-year AA/Aa (or equivalent rated) tax-exempt municipal bond index rate (since these benefits would not be covered by projected assets).

The new GASB discount rate would be the single discount rate that results in the present value of all benefit payments being equal to the sum of the present values in steps (1) and (2). This rate would then be used to calculate the total pension liability and, by extension, the net pension liability. Note that if current assets and projected future contributions and earnings are sufficient to cover all of the projected pension payments, the long-term expected return on plan investments would be used.

A key issue for many plans is how they will project contributions for current members. As provided in *Accounting and Financial Reporting for Pensions*, the projection of future contributions should be based on current contribution policies and practices and include all employer contributions intended to fund benefits of current or former employees and all contributions of current employees. However, it should not include:

(1) employer contributions intended to fund the service costs of future employees, or (2) contributions of future employees.⁸ For most plans that receive actuarially calculated employer contributions, the plan assets should be sufficient to pay the promised benefits and there would be no cross-over point. These plans would use the long-term expected rate of return for all liability measurement purposes.

The Pension Expense

The GASB's new measure of pension expense (PE) is also a significant change. Rather than reflecting the employer's actuarially determined annual required contributions, it essentially reflects the change in the employer's net pension liability, with deferred recognition of certain elements. Components of the new pension expense include:

- Service cost (i.e., normal cost);
- Interest on the total pension liability as of the beginning of the year;
- Changes in the total pension liability over the year (with certain deferrals);
- Differences between actual and projected earnings over the year (with certain deferrals);
- Projected investment returns over the year;
- Employee contributions; and
- Other changes in plan net position.

In calculating the new pension expense, "deferred outflows of resources" and "deferred inflows of resources" are used to defer recognition of certain changes in the total pension liability and to defer differences between actual and projected investment earnings over the year. The framework for these deferrals was established under Concepts Statement No. 4.

Under this framework, an increase in the net pension liability would be considered a "consumption" of net assets, and a decrease in the net pension liability would be considered an "acquisition" of net assets. In determining what constitutes the pension expense in this context, the GASB had to decide which portions of the change in net pension liability are applicable to the current reporting period and which portions are applicable to future reporting periods. If the change is applicable to the current period, it is recognized in the current period. If it is applicable to future periods, it is characterized as a deferred outflow of resources (or a deferred inflow of resources) and recognized over future years, with a portion recognized in the current period.

⁸ *Accounting and Financial Reporting for Pensions*, paragraph 23. See also Appendix C, Illustration 1, Table 1.

For any given year, the remaining unrecognized portions of current or prior changes in the net pension liability would be presented in the basic financial statements. These portions would be included in the deferred outflows of resources account, appearing just below the net assets, or the deferred inflows of resources, appearing just below the net liabilities.

Items Immediately Recognized in the Pension Expense

In considering which items of the pension expense are applicable to the current period, the GASB concluded that the service cost, annual interest on the total pension liability, and projected investment returns over the year should be immediately recognized in the pension expense. Moreover, any changes in the total pension liability due to changes in plan terms (i.e., benefits) should be immediately recognized.

In addition, the GASB decided that any changes in the total pension liability related to inactive employees (including retirees) should also be immediately recognized in the pension expense. This includes any changes in actuarial assumptions or differences between assumed and actual actuarial experience related to inactive members.

Items Deferred and Recognized in the Pension Expense

The GASB concluded that certain changes in the total pension liability due to active employees should be deferred and recognized over a closed period equal to the weighted average remaining service lives of active members. These include changes in actuarial assumptions and actuarial gains or losses related to active employees.

The weighting would be designed to approximate the result that would occur if the changes in total pension liability were recognized for each employee individually over the employee's own expected remaining service life. This may be calculated using weights equal to each employee's own total pension liability.

In addition, differences between actual investment earnings and projected earnings would be deferred and recognized over a five-year closed period. The amortization would be accomplished using a systematic and rational method (e.g., straight line or other systematic amortization methods).

Changes Related to Cost-Sharing Employers

The GASB's EDs would also substantially change the way cost-sharing employers account for and report their pension liabilities and pension expenses. As mentioned above, in the discussion of current standards, cost-sharing employers report their contractually required contribution as their pension expense. In addition, they report the accumulated difference between their contractually required contributions

and their actual contributions as their pension liability on their balance sheet.

Under the GASB's proposed standards, cost-sharing employers would recognize their "proportionate share" of the cost-sharing plan's collective net pension liability, pension expense, and deferred outflows and inflows of resources. Cost-sharing plans would calculate these values for all employers collectively using the same methods as single-employer and agent plans.

A cost-sharing employer's proportionate share would be based on the employer's long-term contributions relative to the total long-term contributions of all employers in the plan. In addition, certain other differences would be deferred and recognized in the employer's pension expense over the weighted average remaining service lives of the plan's collective active employees. These include changes in an employer's net pension liability due to changes in the employer's proportionate share (compared to the prior period) and differences between the employer's actual contribution and its proportionate share of collective employer contributions.

Special Funding Situations

The GASB's proposed standards also establish new rules for "special funding situations." These situations occur when an entity other than a participating employer (i.e., a "nonemployer entity") has a legal responsibility to make contributions to the plan. This legal obligation can be either:

- **Conditional** - based on events or circumstances unrelated to the pensions or
- **Unconditional** - based on a fixed percent of the employing government's payroll, or on a fixed percent of the contribution requirement.

If the nonemployer's legal responsibility is conditional, the contribution is treated as an "on-behalf" contribution (similar to a grant). The employer recognizes its full net pension liability, pension expense, and related deferrals in its financial statements. In addition, the employer also recognizes the nonemployer's contribution as revenue. The nonemployer recognizes the contribution as a non-pension expense.

If the nonemployer's legal responsibility is unconditional, the nonemployer would recognize its proportionate share of the net pension liability, pension expense, and related deferred inflows and outflows of resources in its basic financial statements. If the nonemployer assumes a "substantial" portion of the pension liability, it would provide note disclosures and required supplementary information as if it were a participating employer. The employer would reflect the nonemployer's involvement in financing the pension benefits.

Frequency & Timing of Measures

Under the GASB's proposed standards, a full measurement of the employer's total pension liability should be made at least every two years. While the total pension liability measurement need not be at fiscal year end, it should be done no more than 24 months before the fiscal year end. If the full measurement is not done at fiscal year end, it should be projected to that date and updated to reflect all significant changes. The value of plan assets should reflect plan net position at fiscal year end.

Implications of the GASB's Changes

The GASB's proposed standards intentionally disconnect the pension accounting measures from the pension funding measures. Consequently, information about the actuarial funded status of the plan will no longer be available in the employer's financial statements. While information about the actuarially determined contributions to the plan will be available (for most employers) in the required supplementary information, a measure of the actuarial funded status of benefits will not.

The net pension liability will be included in the employer's balance sheet. Given current economic conditions, this measure of the unfunded liability will likely be quite large. Moreover, since it will be based on the fair (market) value of plan assets (and potentially on tax-exempt municipal bond yields) it will likely be very volatile.

With regard to the pension expense, changes in pension liabilities will be amortized over shorter periods, increasing the amount and volatility of the pension expense. Moreover, the pension expense will be significantly different from the actuarially determined contributions, likely causing confusion about the contributions that are required to fund the plan.

Employers participating in cost-sharing plans will need to recognize a proportionate share of the plan's net pension liability, pension expense, and deferred outflows and inflows of resources. Nonemployer entities with unconditional legal responsibility for plan funding will also need to recognize a proportionate share of the plan's net pension liability, pension expense, and deferred outflows and inflows.

Effective Dates and Transition

The effective dates for the proposed standards would be reporting periods beginning after June 15, 2012, for large single employers with a plan net position of \$1 billion or more in the first period ended after June 15, 2010. For all others, it would be reporting periods beginning after June 15, 2013.

(continued on page 8)

Summary of Current GASB Pension Standards for Governmental Employers Compared with Proposed Changes Presented in the GASB's Exposure Drafts			
For Employers in Single Employer and Agent Multiple-Employer Plans			
	Current Standards	Exposure Drafts	Implications
Pension Liability Recognized in the Employer's Financial Statements (Balance Sheet)	Net Pension Obligation (NPO) - measured as the cumulative difference between the employer's annual required contributions and actual contributions.	Net Pension Liability (NPL) - measured as the difference between the total pension liability (TPL) and the plan's net position (PNP) based on the fair (market) value of assets, with both determined as of the employer's fiscal year end.	Including the NPL on the employer's balance sheet is a major change. The NPL would likely be more volatile than the current unfunded accrued liability, causing confusion about the funded status of the benefits.
Pension Expense Recognized in the Employer's Financial Statements (Income Statement)	Annual Pension Cost (APC) - measured as the employer's "annual required contribution" (ARC) adjusted for interest on the NPO. The ARC is measured as the normal cost (i.e., "service cost") plus amortization of the unfunded actuarial accrued liability over a maximum of 30 years.	Pension Expense (PE) - measured as the current period service cost (based on the traditional entry age normal cost method and the "single discount rate"), plus: Immediate recognition of changes in the TPL due to: (1) interest on the TPL, (2) changes in plan benefits, (3) changes related to inactive members (including retirees), and (4) expected investment earnings; Deferred recognition over the remaining service lives of active members of: (1) changes in the TPL due to changes in assumptions for active employees and (2) differences between assumed and actual actuarial experience for active employees; and Deferred recognition over a closed 5-year period of the difference between actual and expected investment earnings.	The new measure of pension expense would be largely disconnected from the actuarial measure used to fund the benefits. The shorter deferral and recognition periods would increase the volatility of the new pension expense.
Allowed Actuarial Cost Methods	Entry age, Attained age, Projected unit credit, Aggregate, Frozen entry age, Frozen attained age.	Traditional entry age, with allocation of service costs as a level percentage of payroll over the employees' expected service starting at entry age.	Restrictions placed on the use of the entry age actuarial cost method could result in differences between the service cost used for accounting purposes and the normal cost used for funding purposes.
Discount Rate	Long-term expected rate of investment return on plan investments.	A single rate based on: (1) the long-term expected rate of return to the extent current and expected future assets are sufficient to pay projected benefits, (2) or otherwise a 30-year AA/Aa tax-exempt municipal bond index rate.	If tax-exempt municipal bond index rates are incorporated into the single discount rate, the accounting measures of the pension liability will be larger (under current economic conditions) and more volatile than the funding measures of the pension liability.
Asset Valuation Method	Market value or smoothed market value.	Fair (market) value of plan net assets.	Use of the fair (market) value would likely add volatility to the net pension liability and pension expense.
For Employers in Cost-Sharing Multiple-Employer Plans			
Pension Liability	Pension Liability - measured as the difference between the employer's contractually required contribution and the actual contribution.	Pension Liability - measured as the employer's proportionate share of the cost-sharing plan's collective net pension liability. The employer's proportionate share is based on the employer's long-term contributions relative to the collective long-term contributions of all employers in the plan.	Cost-sharing employers (and nonemployer entities with unconditional legal responsibility for plan funding) would show a new and significantly more volatile measure of the pension liability on their balance sheets.
Pension Expense	Contractually Required Contribution - measured as the employer's contractual contribution to the cost-sharing plan.	Pension Expense - measured as the employer's proportionate share of the cost-sharing plan's collective pension expense.	Cost-sharing employers (and nonemployer entities with unconditional legal responsibility for plan funding) would show a new pension expense that would be more volatile than their contractually required contributions.

In transitioning from current standards to the proposed new standards, the GASB states that the new standards should be reported as adjustments of prior periods, with restatement of financial statements for the affected periods. However, the GASB recognizes that it may not be practical for some governments to restate the deferred inflows and deferred outflows. If so, the GASB would not require beginning balances for the deferred inflows and outflows to be reported.

However, the GASB does expect the cumulative effect of applying the new statement to be reported as a restatement of beginning net position for the earliest period restated. Also, the financial statements should disclose the nature of any restatement and its effect in the period that the new standards are first applied. If the prior periods are not restated, the reasons should be explained.

Conclusion

The GASB has requested public comments on the Exposure Drafts by September 30, 2011, and will hold three public hearings in October. The final statements are expected to be released in June, 2012. Given that this is likely to be the last opportunity to comment on the GASB's proposed changes to public pension accounting and financial reporting standards, it is important for stakeholders to review the proposed changes, consider their impact, and provide comments.

The Exposure Drafts are on the GASB's website (www.gasb.org), under the Projects tab, on the "Documents for Public Comment" page.

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