Glossary

ACTUARIAL ACCRUED LIABILITY (AAL) – The total value of pension benefits owed to current and retired employees or dependents based on past years of service.

AMORTIZATION PERIOD – The span of time set to fully pay for actuarial accrued liabilities. To adhere to generally accepted accounting principles (GAAP), governments must use a period of 30 years or less to calculate their net pension or other post-employment benefits obligation and their expense on an annual basis. Some states, which are not in compliance with GAAP, choose longer periods for funding purposes to reduce current contributions.

ANNUAL REQUIRED CONTRIBUTION or ACTUARIALLY REQUIRED CONTRIBUTION (ARC) – The amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period. (This calculation assumes the employer will continue contributing the ARC on a consistent basis.) The ARC is made up of "normal cost" (sometimes referred to as "service cost")—the cost of benefits earned by employees in the current year—and an additional amount that will enable the government to reduce unfunded past service costs to zero by the end of the amortization period.

ASSETS – The amount of money that a pension fund has on hand to fund benefits. The assets (also known as plan assets) build up over time, generally from three sources: employee contributions, employer contributions and investment returns. Plan assets generally are expended to pay pension benefits when due, refund contributions of members who leave the plan before qualifying for benefits and cover the plan's administrative expenses.

ASSUMPTIONS – Estimates made by actuaries about the future behavior of various economic and demographic factors that will impact the amount of pension benefits owed over time. These estimates, of factors such as investment returns, inflation rates and retiree life spans, are used by actuaries to calculate the AAL and the ARC.

DEFINED BENEFIT PLAN – A plan that promises its recipients a set level of benefits, generally for life. In the case of pension benefits, it is based on a "defining" formula that usually includes the number of years served and an employee's salary multiplied by a preset figure (e.g., 30 years x $40,000 x 1.75). In the case of retiree health, the promised benefit is typically the payment of a portion of (or the entire) medical insurance premium. However, it can also be based on a defined formula much like a pension. In this case, a certain monthly income is promised that must be used for health expenses.

DEFINED CONTRIBUTION PLAN – A plan to which the employer, and often the employee, contributes a defined amount (e.g., 8 percent of salary) to an individual account in the employee's name while the employee is in active service, but which does not guarantee any set benefit. The amount available for retirement is based solely on the amount of money that has been saved, along with investment income credited to the employee's account. When these funds are used up by the retiree, the benefit is exhausted.

NORMAL COST – The cost of benefits earned by employees in any given year.

OTHER POST-EMPLOYMENT BENEFITS (OPEB) – Benefits other than pension benefits that an employer provides to former employees as a deferred form of compensation for their services. OPEB is defined by GASB as including (1) post-employment health care benefits and (2) other types of post-employment benefits—for example, life insurance—if provided separately from a pension plan.

PAY-AS-YOU-GO – A method of financing pension benefits or OPEB in which the amount contributed by the employers or employees each year is approximately the amount needed to pay the benefits currently due and payable to retirees (or the premiums currently due and payable to provide for health care coverage or other non-pension benefits for retirees for the current period). Under this method, the source of financing for current benefits often is the employer's current collections.

SMOOTHING – To counter the natural volatility of the stock market, the vast majority of states do not measure the funded status of pension benefits using the current market values of plan assets. Instead, most use methods of determining the actuarial value of plan assets that average out the effects of increases or decreases in market values each year over several years (generally four or five). The effect of this approach is to mute the immediate impact during a severe market drop or spike in growth and to spread it out over time.

UNFUNDED ACTUARIAL ACCRUED LIABILITY (UAAL) – The difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.