

## **Possible Changes in Pension Accounting and Financial Reporting Plain-Language Supplement to Preliminary Views Governmental Accounting Standards Board June 16, 2010**

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### **One Page Summary - Key Proposed Changes**

The Government Accounting Standards Board released a "Preliminary Views" document on Wednesday 6/16/2010 that could lead to very substantial changes in how state and local governments must account for and report their finances related to pension benefits. These are the key changes being considered:

- Unfunded pensions would be reported as a liability on the Balance Sheet. This will cause unfunded pensions to have even more of an impact on the "creditworthiness" of a government.
- The value of unfunded pension liabilities reported on the Balance Sheet will be determined by the "Market Value" of pension fund investments, not an "Actuarially Smoothed" value. If this were in affect today the reported value of unfunded pensions would be dramatically larger. But it would also often increase what would be essentially a "prepaid expense" in situations where the Market Value is greater than total accrued liability.
- The portion of estimated future pension payments already earned that are not calculated to be paid from existing pension assets will be discounted by a high-quality municipal bond index instead of the target rate of return. This will significantly increase the reported value of unfunded retirement benefit liabilities.
- The full amount of yearly "interest" applied to unfunded pensions (either the target rate of return or the municipal bond index rate - unclear) will be reported in the year it is incurred. This will require governments to report the full amount of interest but not yet paid in the "level percentage of payroll" method of UAAL amortization as a yearly expense. This will increase pension expenses during periods of negative amortization.
- The maximum deferral period to report pension expenses related to unfunded pensions will be reduced from 30 years to the average number of years the current staff is expected to be employed - typically between 12 and 15 years. This will very significantly increase reported pension expenses when unfunded pensions are being amortized.
- Although I'm not totally clear on this - it appears that if unfunded pensions are larger than 15% of the total accrued pension liability, the amount greater than 15% must be reported as a current year pension expense. This would have had a huge impact on the County of Mendocino's budget. It's not clear whether or not GASB would require a government with unfunded pensions larger than 15% to report the "excess" as a current expense when the new rules would take effect.
- Governments in "Cost Sharing Multiple-Employer Pension Plans" will have to conform to these changed reporting requirements.


## Introduction

On Wednesday, June 16, 2010 GASB issued two documents regarding proposed changes in its standards for pension accounting and financial reporting by state and local governments.

- Preliminary Views: The “official” technical document prepared for preparers and auditors of state and local government financial statements and actuaries.
- Plain Language Supplement: This Supplement is prepared for users of government financial information - citizens, taxpayers, elected representatives, municipal analysts, and other external users of governmental financial statements, and contains a minimum of technical terminology.

If adopted, these would impose huge changes in the financial statements of the Counties of Mendocino and Sonoma (and all state/local governments). However, I am not clear if it would impose changes in how governments would have to actually eliminate unfunded pension obligations - I'm inclined to think not, but this needs clarification.

GASB is seeking public comment by September 17, 2010, and will hold 3 public hearings for comments and testimony including in San Francisco on 10/14/2010.

This memo is a brief description of key points of these proposals as described in the “Plain-Language Supplement”. In general - this memo focuses on significant changes from current practice (highlighted by the symbol ), as well as general contextual information.

The two documents are available at <http://www.gasb.org/exp/index.html>.

NOTE: While I attempted to correctly interpret the Plain Language Supplement, there are a few areas where I wasn't certain what the intent of the language is, and it's also possible I either misinterpreted the language without realizing it, or the language in fact doesn't clearly convey the meaning.

In other words, this is a good faith effort to convey the key points of these proposed GASB changes, but there could be errors.

## GASB Introduction

GASB proposes to separate standards for pension accounting/reporting from funding calculations. Currently they are very similar. (This makes me think that GASB is not intending to affect the funding of pension liabilities - but rather focuses on accounting and financial reporting related to them.)

☛ The unfunded portion of the pension (**UAAL**) would be **reported as a net pension liability** in the financial statements of the government. That is, **directly as a liability on the balance sheet**, and not only as footnotes (Required Supplemental Information) to the financial statements.

☛ Expected future payments would no longer be discounted by the target rate of return to determine the reported Unfunded Pension Liability. A single weighted-average discount rate would be used based on two calculations:

- The target rate of investment return will be used as a discount rate only for projected benefit payments calculated to be funded by current plan assets,
- ☛ A **high-quality municipal bond index** would be used as the **discount rate** for the currently **unfunded portion of future payments** (i.e. the part that creates the UAAL)

This would typically **increase the value of the UAAL significantly**.

### Reporting Changes in a Government's Net Pension Liability (UAAL) When Should Year-To-Year Changes in UAAL Be Reported As Expenses?

A key accounting and financial reporting issue is when to recognize period-to-period changes in the net pension liability (UAAL) as a cost of a government's operations—as expenses in the accrual-based financial statements.

GASB identifies **6 causes of changes in UAAL** relevant to this issue:

1. Employees work and earn more benefits.
2. The outstanding liability accrues interest.
3. Actual economic and demographic factors differ from what was assumed in the calculation of the pension liability.
4. Changes are made in assumptions about economic and demographic factors.
5. Changes in pension benefits affect benefits associated with employee services in the past.
6. The value of plan net assets changes.

#### **I) Changes to be Reported as Expenses Each Year**

There will be **no change** in the accounting and reporting of changes in UAAL because of Cause 1 above - **employees earning benefits**.

☛ However, GASB appears to be proposing to make a **change** to require **yearly interest on the UAAL** (cause 2 above) to also be recognized and reported as a current year expense.

I say “may be” because the language in the Plain Language document in this regard is a little confusing.

But it appears the interest expense on the UAAL - charged at the rate of the target rate of return - would be reported as an annual expense.

I believe this would **not change** reporting for the “**Level Payment**” method of amortizing a UAAL - that is, where the same amount is paid throughout the amortization period, and therefore the yearly interest is included in the payment.

I think it **would change** reporting in the “**Level Percent of Payroll**” method when “**negative amortization**” is likely to occur. This method establishes yearly amortization payments to be a set percentage of total annual payroll each year. Most governments are projected to have higher payrolls in the future. Therefore future amortization payments would be bigger than the initial payments. This method usually produces “negative amortization” in the early years because the payment is not big enough to even pay all the interest being applied that year. In other words, instead of paying down the loan (the process of amortization), the loan increases in the early years in amounts equal to the unpaid interest being charged each year.

I believe past practice was to only report the part of the annual interest that was actually paid as a yearly expense. This change would **require the full annual expense to be reported**.

If this interpretation is correct, this is also a huge change.

## **2) Changes to be Reported as Expenses over the Remaining Period of Employment**

### **☛ Major Change!**

GASB is proposing to require expenses created by causes 3 through 6 above to be reported in whole no later than the **average number of years the current staff is expected to continue to be employed** by the government.

This considerably shortens the allowable expense-deferral periods **from the current 30 year maximum to more like between 12 to 15 years**.

NOW - it's unclear to me if this also suggests that a UAAL must be eliminated in that same time frame. It's one thing to limit when the expense must be reported - another to limit when the deficit must be eliminated with additional contributions. I think the actual payments to eliminate a UAAL will not be changed, but further clarification is needed.

The increased pension expenses represented by a UAAL will have to be reported within 12 to 15 years.

☛ In addition, if this proposal is adopted, the unfunded pension liability to be reported on the government's “balance sheet” would be based on **“fair value” or “market value” of investments** - not on an actuarially smoothed value! This is huge.

## **3) Investment Earnings**

### **☛ Major Change!**

GASB believes that it is **not generally appropriate** to **include** in the calculation of annual pension expense the amounts that **actual investment returns** were **over or under target**. In general these are expected to offset one another over time. But - GASB proposes a **limit** on that “deferral”.

The annual difference between the assumed and actual investment return would accumulate in the financial statements as deferred inflows (returns above the assumed rate) or deferred outflows (returns below the assumed rate), but only to a certain extent.

☛ **Differences** between assumed returns on pension plan investments and actual returns would be deferred as long as the accumulated deferred inflows or deferred outflows do not exceed the equivalent of **15 percent of the fair value of pension plan investments**. **Any amount beyond 15 percent would be incorporated into the expense calculation immediately**. This is REAL HUGE!

## **Governments in Cost-Sharing Multiple-Employer Pension Plans**

**MCERA** is a “**Cost-Sharing Multiple-Employer Pension Plan**”. (I don’t know if SCERA is as well.) GASB defines these as when “governments pool (share) the costs of providing benefits and administering the plan and the assets accumulated to pay benefits. A single actuarial valuation is conducted for all of the employees of the participating governments combined”.

GASB today does not require actuarial information to be reported in individual government employer financial statements (although I think Mendocino does). These proposals would require such reporting.

**Unlike today, governments in these kinds of plans will be required to report all the same values described earlier in this memo - in proportion to its “share” of the total pension obligation.**