

**Next Year’s Reform of Government Pension Reporting
Why Should Citizens Care?**

**John G Dickerson
8/11/11**

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Introduction

Next summer – **2012** – **new rules** about how state and local governments must report the finances of their pension benefits are going to hit many governments like a ton of bricks¹.

The **current standards** have a **fatal flaw** – they **allow governments to report the pension expenses that created huge unfunded pension debts as if they will happen in the future when the debt is paid. But they won’t happen in the future – they already happened in the past.** They created the huge unfunded pension debt.

The new rules are going to **flush billions of true past pension expenses out of their hiding places** and force them onto government financial statements. The result is going to look like a bloodbath – which it is.

The new rules aren’t about what happens when pension funding plans “work”. It’s about what happens when they don’t. And – the new rules will have no effect on how governments fund their Pension Funds. They are only about how they report their finances. **This isn’t about funding – it’s about reporting the financial truth.**

What we do with the truth is up to us.

¹ This is a short description of how government financial statements are going to change and why that matters. I’m not going to go into details about the new accounting rules – I’ve published two papers about that – one is a broad overview, the other shows the impacts on my home County – Mendocino. They are available on the home page of my website – www.YourPublicMoney.com. The mathematics, accounting and financing for guaranteed benefit pensions (as opposed to guaranteed contributions like 401K’s) is very complex. Although this paper presents the “fundamental truths”, reality is far more detailed and complicated.

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Three Things Concerned Citizens Need to Know about Government Pensions

Pension Expenses Really Happen While Employees Are Working

Government employees **earn their pensions while they are working**. It's part of their compensation even though they won't actually receive the money until after they retire. It's called "deferred compensation". When employees retire they have 100% earned the pensions they will receive.



The cost of pensions is actually **part of the cost of providing government services** while employees are still working. After employees retire their **pensions are the payment of a debt**. The **real economic pension expenses** happen **when employees earn the right to receive future pension payments – never when pensions are actually paid**. That's the payment of a debt.

How Pension Funds are Supposed to Work

Both the government and employees make **yearly contributions to the Pension Fund**. The amount they pay is **supposed to be all that's needed** so that if it earns the Pension Fund's target investment profits all the pensions that are being earned that year will be able to be paid. The **government's payment** to the Fund is that year's **reported pension expense**. When someone retires neither they nor the government should have to contribute any more money – their pension are supposed to be "fully funded".

Reported Yearly Pension Expenses are Estimates – They're Always Wrong

But there's a **big problem – no one knows** how the future will be. How long will retirees live? When will they retire? What will the pension payments be? Will the employee get extra because of an injury? How much will the Pension Fund really earn? The unknowns go on and on.

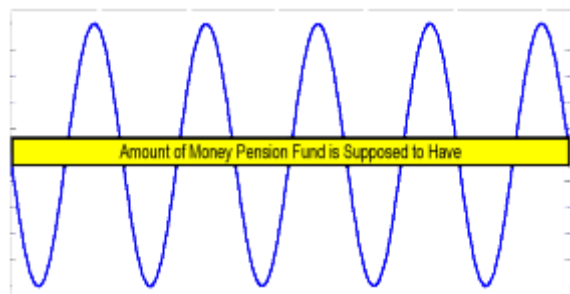
All that has to be estimated – and that means the amount of the **government's yearly contribution** to the Pension Fund that is also that year's **reported pension expense** is not really that year's pension expense – it's an **ESTIMATE**. And **estimates can be wrong**. In fact, because of how many unknowns there are

– we can **safely assume** that the amount reported in any year as pension expense **IS wrong**.

The **hope** is the estimate will be more than the pension expense really is in some years and less in others so that **over time the Pension Fund stays close to where it needs to be**.



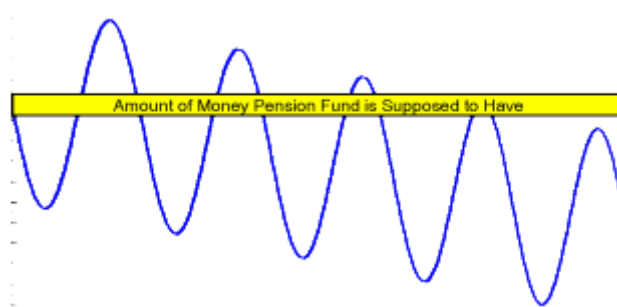
Actuaries Predict Pensions



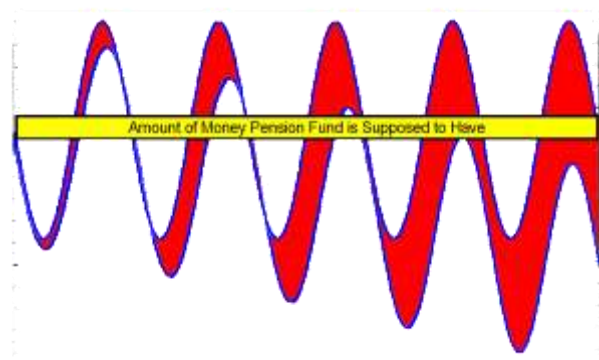
Unfunded Pension Deficits Mean Pension Expenses Were More Than Reported

But **what if** the picture looks like this? What if over the years the Pension Fund – on average – develops more and more of a **gap** between the amount of money it has and what it's supposed to have according to the Actuary's calculations?

ONLY the government must pay more money into the Fund to **eliminate this deficit**. Employees and retirees have no such obligation. They have no risk related to negative Pension Fund performance.



In almost every case **not enough money was put into the Pension Fund in the past** – and therefore the amount of the **reported pension expense in the past was less than what it wound up really being**.



The **red area** between what was supposed to happen and what really happened is the **Pension Deficit** – Unfunded Pensions. It's the amount the **government must pay** in above and beyond what it already did in the past – even though those past “normal” yearly payments were supposed to be all the government was going to have to pay.

It's **also** the amount of **real past pension expenses that have never been reported to the people**.

This is a simplified description that can be made far more complicated – but it captures the essence of what the problem is and why the new rules are so necessary.

Today's Rules Hide Pension Expenses That Create Unfunded Pension Deficits

When a state or local government finds itself in the situation in the graph above it's got a big unfunded Pension Fund Deficit it has to eliminate it by paying extra money into the Fund – money it wouldn't have to pay if its Pension Funding Plans had been achieved. Here's what happens under today's pension finance reporting rules.

Very few governments have enough spare change sitting around in the bank to eliminate the Deficit with a big payment from their own funds. They have **two basic choices** for how to **eliminate Pension Deficits**:

- **Amortization Payments:** This is like the government borrowed the money from the Pension Fund – they make payments over a set number of years and – in effect – are charged an interest rate equal to the Pension Fund's target rate of investment profit. Given today's rules the Deficit is not reported as a liability on the government's Balance Sheet.
- **Pension Obligation Bonds:** They can borrow money from investors by selling Pension Obligation Bonds. They have the same kind of amortization payments, except 1) they are “hard debts” owed to outside investors and are reported as a liability on the government's balance sheet, and 2) they bear an interest rate that is lower than the amount the government is effectively charged if it's making amortization payments.

In **both cases** under today's rules the **pension expense that created the unfunded Pension Deficit is reported in the future as the debt is paid**. But they really happened in the past.

A **crucial goal** of financial reporting is to **confront decision makers with negative results as soon as possible** so that corrective action can be taken to **prevent further deterioration**. The **longer it takes** for decision makers to get necessary feedback about financial problems the **worse the damage** is likely to get. “Timeliness” and “actionability” of information are crucial concerns in financial reporting.

In that context, there are **two big things wrong with the current rules**:

- **Pension Expense:** Governments **defer reporting real pension expenses** that create unfunded pensions **until the resulting pension debt is paid**. This **allows destructive financial behavior** to continue for **decades** without being identified to decision makers and the public.
- **Unfunded Pension Liability:** Governments **don't report Unfunded Pensions as a liability** on government financial statements even though they are **most certainly a legal obligation**. Again officials and citizens aren't seeing the information that would lead to correction action.

Why This Flaw Exists – Actuaries and Cash Flow Accounting

The organization that sets the rules for how governments have to produce their financial statements is the **“Governmental Accounting Standards Board” (GASB** – pronounced “Gas-Bee”). GASB was organized in 1984. Ten years later GASB issued new rules for pension financial reporting. These are the rules in force today with the fatal flaw described in the introduction to this report.

The **reason the fatal flaw exists** is GASB **based its rules** about how to report pension expenses on **how Actuaries plan the funding of Pension Funds**. The most important thing Actuaries do for government Pension Funds is to define how much has to be paid into the Pension Fund each year.

That means governmental financial reporting for pension finances today is based on **cash flow** – which in accounting circles is referred to as **“cash basis accounting”**. Pension expenses aren't reported until the government pays money into the Pension Fund – or to bondholders of Pension Obligation Bonds.²

But governments incur pension expenses when it incurs the legal obligation to pay a pension in the future – not when it actually pays it. This is the basis for what is referred to as **“accrual basis accounting”**.

This was the fatal mistake. Again the actual process is considerably more complex. But the effect has been that thousands of **governments were allowed to report that their pension expenses were significantly less than they actually were** and **delay reporting those real pension expenses decades into the future** when someone else would have to struggle with how to pay the resulting debt.

This is the open barn door through which billions of dollars of unreported pension expenses escaped that created the huge debt now stifling local and state governments across the nation (along with the bad economy). And – this is the door GASB is about to slam shut.

The New Rules Will Flush Billions of Unreported Pension Expenses into the Open

There are **two big changes** GASB's new rules will impose:

- **Much Faster Reporting of Pension Expenses:** Today governments can take up to 30 – even 45 years to report the pension expenses that really happened in the past that created unfunded pension debt. The current rules will force them to report those past expenses within an average of around 4 to 8 years or so – depending on what specifically is causing the unfunded Pension Fund Deficit.
- **Unfunded Pensions Listed on Balance Sheet Liabilities:** Today unfunded pensions are disclosed in footnotes attached to financial statements. After these new rules take effect they will be listed directly on government Balance Sheets.

² The actual accounting processes are considerably more complicated – but this captures the essence.

Pension Expenses

As Reported Today

Today there are two components to the amount governments must pay during a year to the Pension Fund.

- **“Normal” Yearly Contribution:** This is the amount the **Actuary estimates the government must pay to the Pension Fund in a year** so that along with the contribution made that year by employees there will be **enough money to pay the part of future pension payments earned by employees that year**. This estimate is based on dozens of very complex assumptions and calculations such as what the rate of investment profits will be, how long people will live, how long they will work for the government, whether or not they suffer a disability – and dozens more.
- **Unfunded Pension Payment:** If a government has a significant Unfunded Pension Deficit or a balance due on Pension Obligation Bonds, it will pay **additional money** each year to slowly **retire that debt**.

Today the **pension expense** reported in government financial statements is the **Normal Contribution plus** an amount roughly equal to the **part of additional payments to reduce unfunded pension-created debt**. In general, interest is not included.³

What Will Change

- **Normal Contribution:** This will **continue** to be part of each year’s pension expense.
- **The Causes of Unfunded Pensions:** The **Unfunded Pension Payments** will **no longer affect reported yearly pension expense** for two reasons. First, the amortization payments are about cash flow – and the elimination of unfunded pensions. That **puts the reporting of these expenses decades later than when they really happen**. Second, the Amortization Payments method **obscures the real causes of the Pension Deficits** which governments need to identify and focus on.

The **new rules** will **require governments to do what they should have been doing all along – dig into the numbers and figure out what’s creating the unfunded Pension Fund Deficits** and report what it is.

Today the **causes of Pension Deficits** get **all mixed up** with dozens of other things that are happening. Because the Pension Fund Deficit is then amortized over as many as 30 years **no one sees what’s causing the debt**. **No “red flags”** draw attention to what the problem is.

Governments will report the financial impact of **ten factors** that drive pension expenses in three time frames.

- **Immediate:** Many of the factors will immediately impact pension expenses in the year they happen.
- **Spread over 5 Years:** The difference between expected returns on investment and actual returns will be spread over 5 years to reduce the volatility that the stock market would impose.
- **Average Remaining Years Current Staff Will Work:** The differences between a number of the more “obscure” estimates and projections made by Actuaries and what really happens (life span, disabilities, etc.) will be spread over the estimated average number of years the Actuary projects the current staff will work before retiring – which generally is 12 to 15 years.

The number of years it will take to report the pension expenses that create Pension Fund Deficits will depend on the distribution of the impact of these factors among these three time frames – probably 4 to 8 years.

The **higher today’s Unfunded Pension Debt (including Pension Bonds)** is the **more pension expenses will increase** when the new rules are implemented.

The **accumulated debris of unreported expenses** is going to be **forced onto government financial statements all at once**. It’s going to be a shock.

³ Once again – reality is far more complicated, but this captures the essence.

Pension Liability

As Reported Today

Governments today are required to include a type of a footnote called “Supplemental Information” in their audited financial statements. These show the Actuary’s calculations of the value of the Pension Fund’s assets and the amount that should be in the Pension Fund today – total pension liabilities. If liabilities are more than assets then what’s called an “Unfunded Actuarially Accrued (Pension) Liability” (UAAL) exists – or in simpler terms – a Pension Fund Deficit. The UAAL is in fact a debt of the government, but it’s only shown in the footnote, not on the government’s **Balance Sheet**. Governments are required to show these values for the current and previous two years – three in total.

What Will Change

The amount of the **Pension Fund Deficit will be put** in the list of liabilities **on the Balance Sheet**. For governments that regularly pay the total contribution defined by the Actuary (both the Normal Yearly Contribution and any required Pension Deficit Amortization payments) the value of the liability will be roughly the same as the UAAL. For those that are not paying the full defined contribution the amount of the reported liability will be higher.

Footnotes and Supplemental Information

Governments will be required to put tables in the footnotes to their audited financial statements **providing far more information** about what is creating pension expenses and unfunded pensions.

An Example of the Impact – Mendocino County⁴

The County of Mendocino’s Pension Plan reported the market value of its assets was **\$135 million short** of the \$435 million it was supposed to have at the end of June 2010. And the County **still owed \$85 million** on the money it borrowed by selling **Pension Obligations Bonds** in 1996 and 2002 to eliminate previous Unfunded Pension Deficits.

That means the County achieved **less than half its pension funding requirements** over the past 2 decades. If the County’s pension funding plans had “worked” it wouldn’t owe a dime. But they didn’t – and the County owes \$220 million.

The **red part** of the pie is both the County’s **unfunded pension debt AND unreported past pension expenses** that created the debt.

That’s the amount of debt that is **about to be forced onto Mendocino County’s Balance Sheet**, and almost all of those unreported expenses will **hit Mendocino County’s Income Statements within the next 4 years** instead of the 20 or so the County had planned.

Pension Market Value Funding Position
Amount that Should be in Fund = \$435 million
6/30/2009



⁴ Several aspects of the new GASB rules are **very complicated** even for experienced financial analysts to interpret. When GASB releases its new rules next summer they will provide an “implementation guide” to show specifically how accountants need to implement the new rules. Without that guide attempts to project what the impact of the new rules will be on financial statements unavoidably entail significant uncertainty.

Therefore, although these estimates of the pension expense and debt that will be reported when the new rules take effect are my best good faith effort to project what the impact of the new rules will be on the County of Mendocino’s financial statements, the range of possible error is much larger than I wish it was.

About a **half-billion dollars** will be extracted from Mendocino County's weak local economy to pay this debt over the **next 30 years**. Kids not even born yet will pay this debt 3 decades from now. **Not one minute of public service** will be generated, **not one dime of public infrastructure** will be built.

This debt was **entirely created by unfunded pension expenses** that occurred in the past that have **never been reported to the people**. The new rules are going to expose this fact.

I calculate the County of Mendocino's **Pension Expenses** which were **reported as \$9 million to \$13 million** in its 2010 financial statements (depending on which schedule you looked at) **would have been around \$50 million**. This is a huge hit since total operating expenses were reported to be about \$181 million. Given the uncertainty I describe above, I think it's fairly safe to say reported pension expense would not have been below \$40 million.

Mendocino County would have reported a **Net Pension Liability** on its June 30, 2011 Balance Sheet of about **\$140 million**. The County actually reported a total of about \$120 million in long term liabilities and total liabilities of \$170 million. So this would have more than **doubled** the County's reported **long-term liabilities**.

Why Citizens Should Care

What are the **financial duties** of local **government officials to the people**? Here's what I think:

- Tell us the important **truths** about our government's finances.
- Manage Our Public Money **competently** and **transparently**.
- Protect and build our government's **financial strength**.
- Don't force **unfair financial burdens** on our **kids**.

Certainly there are many examples of officials living up to these duties – but unfortunately they have been **spectacularly violated** in too many governments for decades.

According to the most recent report (2009) on Public Retirement Systems by the California **State Controller** the total **Unfunded Pension Deficit** for all **state and local governments** was **over \$80 billion**.⁵ The **Stanford** Institute for Economic Policy Research reported in 2010 their analysis that the true value of **total Unfunded Pension Deficits** for the state and all local governments in California was **closer to \$600 billion**.⁶

Too many officials in our state and local governments **did not tell us the truth** about these expenses and debt. They **did next to nothing** for decades while this devastating debt developed and **obscured** what was happening. Our governments' **financial strength** has been **seriously eroded**. And we have forced a **huge debt on our kids** for which they will **receive nothing**.

Why Should Concerned Citizens Care?

First, this debt is **destroying vital public services**. Second, we should not have created nor continue to create this **huge debt we are forcing our kids to pay**. Third, I fear **governments have promised retirees more than they can deliver**. We are putting many government retirees in **extreme risk**. Fourth, **millions of people** in history paid a **terrible price** so that we are not only accountable to government, but **government is accountable to us**. **We dishonor their sacrifice** when we don't use their gift.

The people didn't hold government officials accountable to fulfill their duties. It's time we do.

⁵ *2009 Public Retirement Systems Annual Report*, California State Controller, 5/24/2011, figure 2 on page xv, available at http://www.sco.ca.gov/ard_locrep_retirement.html

⁶ *Going for Broke: Reforming California's Public Employee Pension Systems*, April 2010, and *The Funding Status of Independent Public Employee Pension Systems in California*, November 2010, Stanford University – Institute for Economic Policy Research, available at <http://siepr.stanford.edu/pubsarchiveorg/1/br>