NEW GASB STANDARDS ADDRESSING PUBLIC SECTOR RETIREMENT SYSTEMS: IMPACT ON FINANCIAL STATEMENTS

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ABSTRACT

On June 25, 2012, the Governmental Accounting Standards Board adopted new standards for accounting and reporting of financial statements for public sector retirement systems. Statement No. 67, Financial Reporting for Pension Plans, and Statement No. 68, Accounting and Financial Reporting for Pensions, replace existing standards in effect since 1994. Pensions for public employees have become a controversial topic as state and local governments struggle with their costs in an economic downturn. As reported by the Pew Center, the gap between states' employee benefit obligations and the funds available to pay those benefits was approximately $1.38 trillion in fiscal year 2011, a 9% increase from the previous year.

The true cost of public employee pensions will become clearer under these modifications which regulate how pension costs are reflected in financial statements. For the first time liabilities will be reported on the balance sheet. These net pension liabilities are calculated as the difference between the total pension liability and the assets set aside to pay current employees, retirees and beneficiaries. This is vastly different than the manner in which governments presently report liabilities, currently computed as the difference between the contributions to a pension plan versus what is actually funded.

This research paper examines the history of the Governmental Accounting Standards Board, previous GASB standards and the provisions included in Standards No. 67 and 68. Also included is the cycle of implementation of these new standards and future implications of these new GASB standards on the proper reporting of financial statements.

INTRODUCTION

Pensions for public employees have been a controversial topic in recent years as state and local governments struggle with their costs in an economic downturn. According to an Office of Personal Management report, the unfunded liability of federal pensions have exploded to more than $761.5 billion in 2012, representing an increase of $139 billion from fiscal year 2011 alone (Morgan, 2013). In a similar report by the Pew Center for the States, the gap between states' public employee benefit obligations and the funds set aside to pay those benefits was approximately $1.38 trillion in fiscal year 2012, reflecting a 9 percent increase from the previous year. These total obligations are computed by $757 billion in pension obligations and $627 billion for obligations to retiree health care (Pew Center for the States, 2012).

For the past twenty years, the methodologies by which governmental entities compute and report liabilities in financial statements were often ambiguous and difficult to comprehend. Although following generally accepted accounting principles (GAAP), the reporting of public pension financial information was far from ideal and modifications were considered (Zorn & Rizzo, 2012). Concluding a process that began approximately five years ago, the Governmental Accounting Standards Board (GASB) recently adopted new standards for accounting and reporting of financial statements for public sector retirement systems. These new statements, Statement No. 67 and No. 68, were adopted by GASB on June 25, 2012 and published on August

15, 2012. Statement No. 67, *Financial Reporting for Pension Plans*, and Statement No. 68, *Accounting and Financial Reporting for Pensions*, replace current GASB Statements 25 and 27, each in effect since 1994 (Kreuze, Langsam, & Penner, 2012). The true cost of public employee pensions will become clearer under these modifications which regulate how pension costs are accounted for and described in financial statements.

REVIEW OF RELATED LITERATURE

A brief perspective of several areas related to public pensions is necessary to illustrate how the implementation of new GASB standards will affect financial reporting. Included in this existing literature review is a background on pension plans, an overview of pension plan types, and the history of the GASB.

HISTORICAL PERSPECTIVE OF PENSION PLANS

Virtually all public-sector, full-time employees in the U.S. are covered by employer-provided pension plans. These public sector pension plans owe their roots to the Colonial era, when the Continental Congress created pension plans for American Revolution military personnel. Starting out as simply an informal promise to existing soldiers and veterans during this era and shortly thereafter made official through formal legislation. This pension system provided to military personnel became more widespread during the Civil War era and was only offered by the federal government. Pensions for workers in state and local governments were first installed during the Progressive Era in the late nineteenth century. This trend continued and by the early1970s all state and most municipal governments offered some form of pension plan for those employees classified as full-time (Kreuze, Langsam, & Penner, 2012).

PENSION PLAN TYPES

Two basic types of pensions provided by governments are defined benefit pensions and defined contribution pensions. The majority of public pensions (approximately 86 percent) are defined benefit pensions, commonly referred to as a traditional pension. A defined benefit pension specifies the benefits to be provided to an employee after the end of their employment. Generally, the two major determining criteria of benefits are salary and years of service (Bureau of Labor Statistics, 2012). Conversely, defined contribution pensions stipulate only the annual contributions to an active employee's account (Barro, 2012). The future benefits received after the end of employment depend primarily on contributions and earnings on the investment of these contributions.

When applying the new GASB standards, identification of the pension plan type is crucial. Three different types of pension plans are recognized:

1. Single employer – provide pensions to the employees of one single employer.
2. Agent multiple-employer – provide pensions to employees of multiple employers. All plan assets are pooled for investment purposes but separate accounts are maintained for each individual employer. Each employer's share of the pooled assets is legally available to pay the benefits of only its employees.
3. Cost-sharing multiple employer – provides pensions to employees of multiple employers. The pension obligations are pooled and plan assets can be utilized to pay the benefits of the employees of any employer (Buckconsultants, 2012).

HISTORY OF GASB

The Governmental Accounting Standards Board (GASB) was created in 1984 to establish generally accepted accounting principles (GAAP) for state and local governmental entities (Niedermuller, 2012). Prior to the creation of GASB, issues in public sector accounting were

addressed by the National Committee on Governmental Accounting (NCGA) of the Government Finance Officers Association (GFOA). In 1989, pursuant to the charter of GASB, an extensive review of the performance of GASB was conducted after five years of existence. This 1989 report suggested only minor modifications to operating procedures of GASB and generally concluded that the GASB had performed well in the public interest (Previts & Merino, 1998).

The GASB is one of two boards that establish GAAP. The other is the Financial Accounting Standards Board (FASB). Generally speaking, GASB maintains jurisdiction over financial reporting by governmental entities while FASB establishes rules for private sector accounting. Both boards are independent, nongovernmental bodies whose members are appointed by the trustees of the Financial Accounting Foundation (FAF). The FAF is an independent, nongovernmental body that is responsible for the basic structure for establishing accounting principles. With respect to the GASB, the FAF appoints GASB members, raises funds, and provides general oversight of governmental accounting standards setting. Both the FAF and GASB are assisted by the Government Accounting Standards Advisory Council (GASAC) (Novy-Marx, 2013).

OVERVIEW OF GASB STANDARDS 67 AND 68

GASB Statements No. 67 and 68 were developed to replace current GASB Standards No. 25 and 27. Statement No. 67, *Financial Reporting for Pension Plans*, requires defined benefit pension plans to prepare two financial statements: a statement of fiduciary net position and a statement of changes in fiduciary net position. Statement No. 68, *Accounting and Financial Reporting for Pensions*, makes changes to the valuation of pension plan liabilities. This statement restricts the way liabilities are calculated with respect to the long-term investment parameters that can be used to discount them over time. Additionally GASB No. 68 also makes changes to the manner in which annual pension expenses are calculated and reported. Important dates and events are illustrated within a chronological timeline in Table 1 (Nicholl & Angelo, 2012).

The implementation of procedures under new GASB Standards 67 and 68 will bring about several general changes in the way governmental entities will configure financial statements. For the first time liabilities will be reported on the balance sheet. These net pension liabilities are calculated as the difference between the total pension liability (present value of projected benefit payments to employees based on their years of service) and the assets (traditionally investments reported at fair market value) set aside to pay current employees, retirees and beneficiaries. This is vastly different than the manner in which governments presently report liabilities, which are computed as the difference between the contributions they are required to make to a pension plan in a given year versus what is actually funded (Roybark, Coffman, & Previts, 2012).

TABLE 1
Chronological Timeline for Issuance of GASB Standards 67 and 68

Date	Important Event
2006	GASB began preliminary review of financial reporting for public sector retirement systems.
2008	GASB began comprehensive review of exiting reporting standards under GASB Statements No. 25 and No. 27.
March 2009	GASB issued an "Invitation to Comment" asking respondents to address several specific aspects of public sector pension accounting.
June 2010	GASB released its *Preliminary Views* on needed revisions to existing pension accounting standards.
July 2011	GASB released *Exposure Drafts* summarizing public comments and amended GASB Statements No. 25 and No. 27.
June 2012	GASB passed Statement No. 67 and No. 68, adopting new standards for public sector retirement systems.
August 2012	GASB published final documents for Statement No. 67 and No. 68.
June 2013	Provisions in Statement No. 67 become effective for all financial statements.
June 2014	Provisions in Statement No. 68 become effective for all financial statements.

Table 2 represents an overview of the general areas which are addressed in GASB 67 and 68. Additional clarification and discussion is needed to fully explain how these areas are implemented into accounting standards. A more detailed analysis of the specific terminology will be discussed in subsequent sections.

TABLE 2
Changes to Occur Under GASB 67 & 68

	Old Provision	New Provision
Calculating Funding Status	Asset values smoothed over a given period.	Fair market value of assets to determine funded status for balance sheet
Reporting Funding Status	No requirement to post plan's funding status.	Pension plan's funded status will be reported on balance sheet.
Pension Expense	Annual required contribution defined the pension expense	Changes in net pension liability included immediately on balance sheet instead of being amortized over time.
Investment Return Assumptions	System used expected return on assets to discount liabilities.	If projected assets do not cover benefit payments, plan will be required to use tax-exempt bond to discount excess portion of expected benefit payments.

PENSION LIABILITY

Presently under Statement 27, the amount reported as a pension liability on governmental financial statements results from a comparison of the actuarial required contribution (ARC) compared to actual employer contributions. Governmental employers who underfunded their ARC reported a year-to-year increase in their liability, known simply as a net pension obligation. Additionally, employers who consistently fully funded their ARCs reported no liability, while

employers who overfunded reported this surplus as an asset (Tysiac, 2012). It is noteworthy that the amounts reported as assets or liabilities do not adequately reflect the funding position. Instead, the reported amounts represent cumulative funding of contribution requirements since the transition date set (1986 for most governments) by the GASB within Statement 27 (Zorn & Rizzo, 2012).

When Statement 68 becomes fully implemented, a new approach to recording the net pension liability will be required and ideally a more accurate measure of the unfunded actuarial liability. This new, recorded liability is termed the net pension liability (NPL). NPL will be calculated by utilizing the present value of projected benefit payments less the amount of the pension plan's fiduciary new position (previously known as net assets). This new methodology of liability measurement will result in significant changes on net position (Tysiac, 2012). Generally speaking, employers who previously reported a net pension asset may now incur a large liability while those who reported a net pension liability will report a much larger liability (Barro, 2012).

DISCOUNT RATE

Under Statement 27, each employer provides their actuary with a long-term assumed rate of return (RoR) on investments. This assumed RoR is used to discount future projected benefits paid to the employee back to the present value. The higher the investment RoR assumption, the lower the present value of the future benefits to be provided. Fairly common were assumed rate of returns between 7 and 8.5 percent, particularly for large pension funds. The justification for using these higher returns is that pension funds were properly positioned to follow a long-term investment strategy that invested in balanced portfolios containing some high risk/high reward options. Studies conducted over 15 to 20-year horizons displayed that significant portfolios implementing long-term strategies could achieve these returns over time.

ACTUARIAL METHODS

Under GASB Statement 27, employers were allowed to select from six actuarial cost methods to determine the ARC. Two of these methods, level percentage of projected payroll or the level dollar amortization method, were allowed to attribute the unfunded actuarial liability to accounting periods. This method is quite different under GASB 68, as calculation of the actuarially required contribution is no longer required. One notable exception to this rule exists in that disclosures will still be required for plans that have a legal requirement to provide funding on an actuarially determined basis. Statement 68 requires the present value of benefit payments to be attributed to periods of employee service using the entry-age normal actuarial cost method (Nicholl & Angelo, 2012).

Actuarial valuations (AV) were required to be performed biennially under previous GASB 27. While the AV date was not required to correspond with the employer's accounting year end, a consistent date was required from year to year. Additionally, the ARC reported for a fiscal year must be based upon the results of an actuarial valuation performed at a date not more than 24 months before the beginning of the employer's fiscal year (Tysiac, 2012). To illustrate an example, when reporting as of December 31, 2013, the AV date could be no earlier than January 1, 2011.

New actuarial requirements under GASB 68 vary slightly based on the plan type of employer (single, multiple employer agent, or multiple employer cost sharing). These requirements for each of the three plans are summarized briefly.

- Single and multiple agent employers – under Statement 68, two important dates are relevant: AV and measurement date. The AV is performed to measure the total pension liability, which is computed by the present value of projected benefit payments to active

and inactive employees attributable to past periods of service. The AV date can be no earlier than 30 months and one day before the most recent fiscal year-end. Measurement date indicates when the net pension liability is determined. Net pension liability is computed as the total pension liability less the plan's fiduciary new position (Novy-Marx, 2013).

- Cost-sharing employers – under current GASB standards, a cost-sharing employer's pension expense is its contractually required obligation to the cost-sharing plan. Its pension liability is the accumulated difference between required contributions and its actual contributions over time. Under GASB standards, these employers will be required to report their "proportionate share" of the plan's net pension liability. While methods per employer could vary, proportionate share could be based upon total employer contributions or payroll to determine employer contribution rates. (Zorn & Rizzo, 2012)

MOODY'S INVESTOR SERVICES

Moody's Investor Services proposed four adjustments to report governmental pension information to address changes brought about by GASB Statement 68. First, actuarial accrued liability (AAL) would be discounted using a high-grade, long-term corporate bond index rate. For adjustments to 2011 and 2012 pension data, the discount rate would be 5.5 percent, which is based on Citibank's Discount Curve. This Citibank rate is much less then the typical range of 7.5 to 8.25 percent utilized by most plans. To implement the discount rate adjustment, Moody's proposes using a 13-year duration estimate as an accurate measure of the average life of benefit payments. The result would be that each plan's AAL would be projected forward for 13 years at the plan's reported discount rate, then subsequently discounted back at 5.5 percent. Second, asset valuation smoothing would be eliminated in favor of reported fair value of assets as of the actuarial reporting date. Moody's assumption is that asset smoothing can distort the size of unfunded liabilities and limit comparisons across years, particularly when there have been wide swings in investment performance (The Segal Company, 2012a).

Third, annual pension contributions for states would be calculated using a hybrid calculation of new discount rate and uniform UAAL amortization. Generally speaking, there are two important components of annual contributions:

1. Employer normal cost (ENC) – calculated as the employer's share of liabilities accumulated in a given year of annual employee contributions.
2. Amortization payment – equal to the amount needed to eliminate the gap of unfunded liability over a certain amortization period. This payment is typically calculated as a level percent of payroll.

Moody's proposes adjusting the ENC to reflect its common 5.5 percent discount rate and the amortization payment to reflect its adjusted unfunded liability, a common amortization period, and a level-dollar funding approach. Finally, for multiple-employer cost-sharing pension plans, pension liabilities would be allocated in direct proportion to each employee's share of the total contribution. According to Moody's, this technique is very similar to a standard in GASB 68.

If all of Moody's changes are ultimately adopted, it estimates that the unfunded actuarial accrued liability (UAAL) for all 50 states and approximately 3,500 pension plans for local governments will increase dramatically. These liabilities could triple from $766 billion to $2.3 trillion. Despite these dramatic differences, Moody's does not project that the proposed changes will lead to rating changes for any of the state governments. However, it is very likely these changes will have an adverse effect on ratings for local governments. The rationale for this adverse impact is that in local governments, the adjusted liability is outsized for rating category

and absent of mitigating factors such as flexibility to respond to higher costs (The Segal Company, 2012b).

FUTURE IMPLICATIONS

Existing GASB standards base pension expense on the ARC, which mandates unfunded liabilities to be amortized over a time period no greater than 30 years. Additionally, funded status information does not appear in financial statements but is included in the footnotes. This treatment of unfunded liabilities will change drastically after implementation of GASB 67 and 68. New accounting standards will redefine pension expense and require inclusion of funded status information on the balance sheet.

New accounting standards outlined in GASB 67 and 68 will have significant consequences upon state and local governments. First, reporting net pension liabilities on financial statements (rather than reporting the historical difference between actual contributions and the ARC) will modify the focus of these statements. Specifically, the focus will change from the long-term commitment to fund pension obligations to a short-term emphasis on the funded status at a specific point in time. Second, an immediate recognition of changes in liabilities will result in a pension expense drastically different from the contribution amounts. The emphasis on immediate recognition of liability may cause policymakers to choose short-term expediency rather than consider future implications. Finally, a natural comparison between the NPL of the unfunded accrued liability and contribution requirements will cause confusion to stakeholders. Although one measurement is strictly for accounting and other measurement is for funding purposes, communication of these differences will be challenging and cause ambiguity.

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