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GASB's Proposed Accounting Changes Could Exacerbate States' Fiscal Challenges



By Keith Brainard

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The Governmental Accounting Standards Board is reviewing accounting standards for public pensions. The review has been under way for several years and is part of the agency's normal practice. However, the current review coincides with one of the largest market downturns and deepest recessions in recent history. State and local government sponsors of public pensions have been deeply affected by these recent events.

Public pension plan sponsors welcome accounting-standard changes that increase transparency and make accounting information more useful to decisionmakers. However, some changes under consideration may have the opposite effect, by increasing the volatility of funding levels and required costs without improving the usefulness of the accounting information. The proposed changes could exacerbate the fiscal challenges that states and local governments now face.

\$2.6 Trillion in Assets

Pension plans for employees of state and local government hold more than \$2.6 trillion in assets to pay the retirement benefits of some 15 million working and 7.5 million retired public employees. These plans pay out more than \$160 billion each year in retiree benefits. Unlike other government programs, state and local government retirement systems are advance-funded. Public employer dollars go into a trust during the working lives of employees. In most cases, the employer dollars are matched by mandatory employee contributions, and the money is invested in global financial markets based on a long-term investment strategy. Benefits are paid out incrementally during the remaining lives of retired employees. This financing structure over the long term enables a

significant portion (73 percent) of benefit costs to be paid for by investment returns and employee contributions.

Public retirement systems generate positive economic returns, benefitting virtually every state and city in the nation. A recent study found that every tax dollar contributed to state and local pensions generates \$11.45 for the national economy.¹ Thus, the financial health of state and local retirement systems is critically important to the economic well being of state and local governments, their employees and retirees, and their citizenry.

¹ National Institute on Retirement Security, "Pensionomics: Measuring the Economic Impact of State and Local Pension Plans," February 2009.

Multiyear Review

The accounting standards for these important programs are set by the Governmental Accounting Standards Board. GASB has been conducting a multiyear review of its Statements 25 and 27, which provide guidance on how state and local governments should recognize and measure their pension obligations. GASB is taking a deliberative approach to this review, issuing preliminary views for comment before releasing its exposure draft.

Here is how GASB described its preliminary views:

"A Preliminary Views is a Board document designed to set forth and seek comments on the Board's current views at a relatively early stage of a project...A Preliminary Views generally is issued when the Board anticipates that respondents are likely to be sharply divided on the issues or when the Board itself is sharply divided on the issues. Because the Board anticipates that respondents likely will express a range of differing views on major issues related to the recognition and measurement of employers' pension liabilities and expenses, it believes that a Preliminary Views, rather than an Exposure Draft, is appropriate. Although some Board members may disagree with certain aspects of the Preliminary Views and some may feel more strongly about certain provisions than others do, the Preliminary Views represents the Board's current views on the issues discussed in this document."

GASB further said that the purpose of reviewing Statements 25 and 27 is to achieve its "financial reporting objectives of accountability and decision usefulness, including enabling users of financial reports to assess the extent to which interperiod equity has been achieved."

As part of its review process, GASB has raised questions about:

- whether public pension liability calculations should reflect future costs, including those for future service credit, salary increases, and cost-of-living adjustments;
- how future liabilities should be measured;
- whether and for how long plans should be able to phase in their investment gains and losses; and
- what is the maximum period in which plans should be allowed to pay off their unfunded liabilities, which are the portion of benefits that have been accrued but not advance-funded.

These issues may seem arcane and technical. However, GASB's decisions are likely to have a major effect on public pension plans' reported funding levels and required costs, and the ability of their sponsors to deal with the challenges created by the recent economic downturn.

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'Delinking' Accounting and Funding

Although most funding shortfalls currently associated with public pension plans are not a result of imperfect accounting standards, the public pension community supports accounting changes that would produce better information about the ability of government plan sponsors to finance promised benefits and that could help plan sponsors in setting appropriate benefit and contribution levels.

A large segment of the public pension community is concerned that some of the proposed changes in the Preliminary Views (115 PBD, 6/17/10) would not be helpful in achieving those objectives. In particular, a proposal to move away from the funding orientation of governmental pension accounting and reporting may not only fail to improve financial reporting but also could make the reporting worse. Delinking accounting from the actuarial funding characteristics of public pension plans would dangerously diminish the “decision usefulness” of current reporting. Better information on which to base allocations of scarce resources in a budget is more important than ever in these difficult economic times.

Applying corporate-like standards to public pension plans would lead to significantly greater volatility in both funding levels and costs for these plans as well. Such volatility is untenable in a public budgeting environment that requires costs to be held relatively level so they are borne equally by current and future taxpayers.

Some of GASB's proposed changes would simply add confusion. However, restricting flexibility by proposing changes in amortization and asset smoothing could not come at a more inopportune time, when plans and their sponsors are absorbing the effects of the market downturn.

Finally, reporting that enables decisionmakers to assess intergenerational equity may be an important goal, but only if it recognizes that cost-shifting can occur in both directions. It is important that the government not shift costs to future generations, and it is equally important that any current generation not pay more than its fair share of costs for services that benefit future generations as well as the present one.

Accounting Differences

Several years ago GASB published a white paper titled, “Why Governmental Accounting Is—And Should Be—Different.” As the title implied, the paper described key differences in accounting methods and standards for the public and private sectors, differences that reflect their dissimilar operations, revenue sources, stakeholder groups, and longevity.

The GASB paper said that states and local governments have the ability to continue operating in perpetuity. Public pensions operate over very long time frames. Relationships between pension plans and their employer sponsors and employees often last decades. Likewise, pension assets are invested over very long periods, and actuarial assumptions—projections of future demographic and economic events—are developed to reflect decades of experience. Because of their long time horizons and their perpetual nature, public pension plans are considered “going concerns,” a term describing an entity that is expected to continue operating without threat of liquidation for the foreseeable future.

No Liquidation Concerns

The possibility that a corporation could go out of business or be acquired contrasts sharply with the “going concern” nature of public-sector entities. Some are calling for changes in public pension accounting standards to imitate those in place for corporate plans. Yet corporate plan sponsors have been actively seeking to amend corporate accounting standards since the 2008 market downturn, an event that has greatly increased volatility in corporate pensions when most companies are trying to work their way out of a recession.

Applying corporate-like standards to public pension plans would lead to significantly greater volatility in costs and funding levels for public plans as well. Such volatility is untenable in a public budgeting environment that requires costs to be held relatively level so they are borne equally by current and future taxpayers.

Studies indicate that the leading cause of corporations' abandonment of traditional pension plans has been the uncertainty and volatility of required costs, which are a direct result of the use of these accounting standards. Although the standards applied to corporate pensions may be appropriate, there is no good reason to apply these same standards to public pensions, and there are plenty of reasons not to do so.

Public pension liabilities should reflect the presumed perpetuity of the plans and their governmental plan sponsors. The liabilities also should reflect the guarantee of public pension benefits by state constitution, statute, case law, and other legal provisions. Finally, they should reflect actual and projected investment returns of public pension funds.

For workers outside the public sector, laws, regulations, accounting standards, and retirement plan practices implemented during the past 30 years have diminished retirement security.

Public pension plans, their representative organizations, and members of the public pension community will be responding to GASB's proposals. GASB is expected to consider these and other responses to the Preliminary Views, and this fall it is scheduled to issue an Exposure Draft of proposed changes to Statements 25 and 27. An Exposure Draft reflects a more definitive, close to final, set of views of the GASB members.

Essentials of Retirement Security

Pension plans, when they are allowed to work, are the most economical way to provide reliable retirement security. Pension policies have long-term consequences, and minor adjustments can have major effects on costs and retirement security. For workers outside the public sector, the laws, regulations, accounting standards, and retirement plan practices implemented during the past 30 years have diminished retirement security.

Retirement security benefits everyone, and those with a role in shaping retirement policy and plan design should recognize and support the core elements of public pension plans that promote retirement security while meeting the objectives of all stakeholders. These are the four core elements:

- cost-sharing between public employees and employers,
- pooled assets invested by professionals over a long time frame,
- retirement benefits that reflect employees' salary and length of service, and
- retirement benefits that cannot be outlived.

These essential elements should be the pillars of any retirement plan design or policy.

More information is in GASB's Preliminary Views [document](#) and the [text](#) of its Plain-Language Supplement.