Why are there GASB standards?

- Ultimately, the Governmental Accounting Standards Board is concerned with how state and local governments present accounting and financial information.

- Reasons behind GASB changes
  - Improve consistency and transparency
  - Enhance decision usefulness of pension information
  - Assist users in evaluating accountability and inter-period equity related to pensions

- GASB’s authority extends only to accounting and financial reporting, not to funding
Underlying Principles

- Pensions are part of the exchange between employees and employers
- The pension plan is primarily responsible for paying pension benefits to the extent the plan has sufficient assets
- The employer is primarily responsible for paying benefits to the extent the plan does not have sufficient assets

GASB Effective Dates

- Final Statements issued last summer with effective date for plans for years beginning after June 15, 2013 and for employers for fiscal years beginning after June 15, 2014.
### Revised Statements 67 (old 25) and 68 (old 27)

- Divorce accounting and funding.
- Net Pension Liability (NPL) moves to balance sheet of employers. NPL is:
  - Actuarial accrued liability (referred to in statements as Total Pension Liability or TPL) based on Entry Age Normal funding method, less
  - Plan’s Fiduciary Net Position (market value of assets).
- Annual pension expense (PE) or pension income (!) with no direct relationship to actuarially determined contributions. PE is:
  - EAN normal cost
  - Interest on the NPL
  - Immediate recognition of changes in active and inactive liability due to plan amendments
  - Deferred recognition (over average remaining service life) of changes in active and inactive liability due to assumption changes and actual experience
  - Deferred recognition of investment gains and losses over five years.
Average Remaining Service Life

- For active employees this is the average time left in years from the valuation date to the expected termination date of the employee.
- The average varies depending on the demographics of the group and the retirement eligibility of the plan.
- For general employees an average of 7-10 years is likely. For police/fire groups it may likely be 7-14 years. Both are dependent on retirement eligibility and demographics.
- The twist from GASB is that the average must include the expected service life of the retirees, which is arguably zero.
- So if a plan has a retiree population equal to its active population, the average remaining service life used in developing PE will be half the active number.
- This will result in very rapid recognition of experience gains and losses as well as liability changes due to revised assumptions.

Revised Statements 67 (old 25) and 68 (old 27)

- Deferred Inflows and Outflows (DI/O) created.
  - Accounts that hold the unrecognized changes in NPL.
  - Separate line item not included in assets or liabilities but shown on the face of the balance sheet.
- Extensive footnote disclosure and supplementary information required. For example (10 year schedules are built prospectively with the exception of the ADEC schedule):
  - 10 year schedule of changes in NPL
  - 10 year schedule of TPL, Fiduciary Net Position (FNP) and NPL
  - 10 year schedule of, if calculated, Actuarially Determined Employer Contributions (ADEC) and actual employer contributions
  - 10 year schedule of money-weighted actual rates of return net of investment expenses
  - Method used to determine the long-term investment return rate
  - Real rates of return by asset class and whether they are arithmetic or geometric returns.
  - NPL at +/- 1% of interest rate used for expense and liability determination.
Assumed Investment Return

- Based on long-term expected return of assets held in trust unless fund is expected to be depleted before all benefit payments are made.
  - Long Term ROR is net of investment expenses but gross of administrative expenses (administrative expenses will be included in the asset projection as an additional cash outflow item).

- If fund is expected to be depleted before all benefit payments are made then a blended single rate that is the equivalent of the long-term rate while assets are available and a municipal bond index for the remaining period.
  - Municipal bond index is general obligation non-taxable 20 year bonds with AA/Aa or higher rating.

Projecting Assets

- In determining whether a single equivalent rate must be calculated assets need to be projected into the future.
- Project benefit payments for the closed group of plan participants as of the VD.
- For employer contributions two conditions are checked:
  - Contributions set statutorily or contractually?
  - Contributions subject to formal, written funding policy?
- If either condition is met, then look to the past five-year history of compliance and adjust as necessary for the projection.
- If neither condition is met then use a five-year average of actual contributions, as a dollar amount, a percent of payroll or a percent of the actuarially determined employer contribution (ADEC).
- Cannot count normal cost contributions for future hires, but can recognize any UAL payments made based on future hire payroll.
- No “safe harbor” provided for this determination but there is a bow to the possibility that potential asset depletion date might be calculated through “other” methods.
Ad-hoc COLAs

- Ad-hoc COLA’s that are "substantively automatic" must be included in determining the Total Pension Liability.

- In determining this the historical pattern of granting the changes and the consistency in the amounts are taken into account.

- Offsetting these would be any evidence that the changes might not continue in the future.

- Who makes the call?

Cost-Sharing Employers

- Employers will need to report proportionate share of NPL, PE and DI/O.

- Proportionate share is the individual employer’s projected long-term contribution effort as compared to the total plan contribution effort.

- If this is not easily obtained, the share may be determined using a basis associated with the manner in which employer contractually required contributions are assessed. For example if all cost-sharing employers contribute at the same rate of pay, then presumably the ratio of the employer’s payroll to the plan’s total payroll could be used.

- The impact of changes in the proportionate share from year-to-year will have to be determined and amortized in the same manner as actuarial gains/losses.

- Single employer plans at the plan reporting level MAY be cost-sharing at the employer reporting level.
Calculation and Reporting Timing and Frequency - **Plans**

- **Reporting Date (RD)** – plan’s fiscal year end.
- **Measurement Date (MD)** – date as of which TPL, FNP, and NPL are determined – is the RD for plans.
- **Valuation Date (VD)** – date as of which total pension liability (TPL) is determined.
  - Actuarial valuations must be at least biennial.
  - No earlier than 24 months from RD.
  - If VD before RD then TPL is rolled forward to RD.

Calculation and Reporting Timing and Frequency - **Employers**

- **Reporting Date (RD)** – employer’s fiscal year end.
- **Measurement Date (MD)** – date as of which TPL, FNP, NPL, PE, and DI/O are determined.
  - No earlier than previous fiscal year end.
  - NPL and PE reported on RD without adjustment.
- **Valuation Date (VD)** – date as of which total pension liability (TPL) is determined.
  - Actuarial valuations must be at least biennial.
  - No earlier than 30 months plus 1 day from RD.
  - If VD before MD then TPL is rolled forward to MD.
- Timing is to be consistently applied so choose well!
Employer Timing

No more than 30 months plus one day

VD | MD | RD

No more than one year

Timing Examples

- **VD = MD = RD**
  - Most straightforward as long as there is sufficient time to complete the valuation before the financial statements are published

- **VD = MD < RD**
  - NPL, PE and DI/O measured by the valuation are reported without adjustment in the financial statements

- **VD < MD <= RD**
  - TPL calculated as of VD and rolled forward to MD
  - FNP (market value of assets) measured as of MD
  - Resulting NPL reported without adjustment in the financial statements
  - PE and DI/O determined as of MD and reported without adjustment in the financial statements
  - Most complicated timing situation so avoid if possible
Considerations

- The disclosure requirements for both the plan and employers are extensive.
- The changes may not have a big impact on balanced budget requirements but will most likely affect loan and banking covenants.
- There do not appear to be any requirements that plans provide detailed information to employers in meeting GASB 68 requirements. For cost-sharing employers who does what will have to be worked out.
  - Allocation of NPL and PE
  - Note Disclosure and RSI development
  - If employer does the work (and employer is in the best position to do so) how will cost be covered?

Key Implications

- New rules represent a shift from long term funding to short term snapshot of funded status
- Putting the NPL on the balance sheet of employers will add a large and unstable element to the financial statements
- Two different "cost" numbers (funding and accounting) will present a communications challenge and debate about the "true cost"
- Current ARC served as a de facto contribution standard. With no ARC, some systems may need to create a formal funding policy
Key Implications

- Significant additional work for cost sharing plans
- Will require greater coordination between the plan and employer, as well as the actuary and the auditor
- Having the NPL on the balance sheet may mean more involvement by auditor in actuarial results. Could impact the roles of auditor and actuary
- The disclosure requirements for both the plan and employers are significant.
- The effective dates provide some time to develop the templates that will be needed as well as to give GASB staff time to hopefully produce an implementation guide.
- The implications of adding significant liability to local public entities’ balance sheets are not clear. May not have a big impact on balanced budget requirements, but will most likely affect loan and banking covenants.

Setting Funding Policy
Funding Policy Structure

There are normally three major components of a funding policy statement:
- Funding Goals
- Benchmarks
- Methods and Assumptions.

Funding Goals

The goals describe the objectives the Board has in funding the benefits.

Some common goals are:
- Full funding (100% funded ratio)
- Contribution rate stability
- Intergenerational equity
- Targeted funding ratio, either greater than or less than 100%.
Benchmarks

- The benchmarks indicate how progress toward meeting the stated goals will be measured. They can include:
  - Funding ratio
  - Experience test (ratio of net gain/loss to accrued liability over time)
  - Short condition test (assets compared to retiree liability and active member contribution balances)
  - Contribution rate history
  - UAAL amortization period.

Methods and Assumptions

- The following elements are usually addressed in funding policy statements:
  - Actuarial cost method
  - Asset smoothing method
  - Amortization of Unfunded Actuarial Accrued Liability (UAAL) policy
  - Funding target.
Actuarial Cost Method

Still several acceptable methods:
- Entry Age Normal
- Projected Unit Credit
- Aggregate
- Frozen Initial Liability.

Entry Age Normal Method

- Projects salary and service to retirement date.
- Allocates liability over career as level % of payroll.
- Normal cost is equal to % times expected pay.
- Used by approximately 75% of public plans
- Is required by revised GASB standards for accounting purposes.
Asset Smoothing Methods

- Asset portfolios that include significant equity allocations are volatile.
- Volatile asset performance can cause erratic contribution requirements.
- Smoothing of assets reduces volatility.
- Makes budgeting for contributions easier.

Asset Smoothing Period

- Originally established to theoretically match stock market cycles.
- Most common period is five years.
- Longer periods are sometimes criticized as unreasonable.
Asset Smoothing Corridor

- Used to limit divergence between the market value and actuarial value of assets.
- More common with longer smoothing periods.
- 80% - 120% of market value is a typical corridor but current thinking is that it should be wider.

Asset Smoothing Method

- Issues include:
  - Length of smoothing period.
  - Corridor and, if one, it's size.
  - Fixed or rolling smoothing periods.

- ASOP 44 requires a method that:
  - Is likely to return to market in a reasonable period and likely to stay within a reasonable range of market, or
  - Has a sufficiently short period to return to market or sufficiently narrow range around market.
Amortization of UAAL

- Open or closed period.
- Level percent of payroll or level dollar.
- Separate amortization by source of UAAL.
- Length of amortization period.
- Somewhat dependent on whether employer contribution rates are fixed or not.

Open Amortization Periods

- Amortization period is fixed instead of decreasing each year.
- Can result in negative amortization if combined with increasing payroll assumption.
- Can result in perpetual UAAL.
- Helps dampen contribution volatility.
Closed Amortization Periods

- Amortization period decreases one year each year.
- UAAL will be paid off at end of period.
- Contribution volatility increases as period decreases.

Separate Amortization Bases

- Each year, new closed bases are set up.
- Separate bases can be set up for gains/losses, plan amendments, and assumption changes.
- Can have differing amortization periods for different kinds of bases.
Length of Amortization Periods

- Can range from zero to infinity.
- Ideally would be similar in length to the average future working lifetime of active members (consistent with principles of accrual accounting).
- Before pending revisions, GASB restricted the maximum period to 30 years.
- Private sector uses 7 years.
- 15 – 30 years is typical of public plans.

Methods of Amortization

- Level Dollar
  - Same dollar amount for entire period
  - Similar to fixed rate home mortgage
  - Will decrease as percentage of pay as payroll increases

- Level Percentage of Pay
  - Amortization payment increases by a fixed percentage each year which is the assumed rate of payroll growth
  - Can result in negative amortization in early years, depending on amortization period
  - Intended to remain a constant percentage of payroll
Funding Ratio Comparison

Common Goals When Pre-Funding

- Full funding (100% funding ratio)
- Contribution rate stability
- Intergenerational equity
- Targeting funding ratio > 100%
- Targeting funding ratio < 100%
Goal of Full Funding

- Actuarial cost methods (in general) are designed to reach 100% funding.
- Open amortization periods can delay (sometimes indefinitely) reaching full funding.
- What happens when goal is achieved?

Goal of Contribution Rate Stability

- Desirable for consistent budgeting.
- Asset volatility and other gains and losses must be absorbed.
- Amortization period of UAAL will fluctuate to accommodate volatility.
Goal of Intergenerational Taxpayer Equity

- Retirement benefits can be considered a form of deferred compensation.
- This deferred compensation should be recognized while the member is employed and be fully funded by the time of retirement.
- Taxpayers that receive services pay for the retirement benefits of service providers.
- Consistent with the principles of accrual accounting.

Goal of Targeting Funding Percentages Other Than 100%

- Target > 100% - allows for a cushion against adverse experience.
- Target < 100% - can mitigate pressure to improve benefits (spend “surplus”).
Funding Target

- The ultimate funding target should be 100% or more at some point in the future.

- How that is accomplished and over what timeframe will be dependent on both statutory restrictions and the funding goals established by the Board during the policy setting process.

- Projections can play a major role in measuring progress toward whatever funding goal is established, particularly with tiered benefits.

About Projections

- Annual actuarial valuations are a "snapshot" of the financial position on the valuation date, based on the existing active and retired members.

- Projections simulate future actuarial valuation results over a forecast period (generally 20-50 years depending on the situation) by "creating" future new hires and performing valuations using the projected membership.

- Benefit changes from new tiers are reflected for the affected employee groups as they become effective.

- Deterministic projections use one set of demographic and economic assumptions over the projection period. Stochastic projections provide results of thousands of runs under randomly determined assumptions (usually economic).

- Projections provide information on trends in financial measurements. They do not provide absolute results.
Final Thoughts

- Participating employers need education on what’s coming and what it means. Who is in the best position to provide that education, but how will the cost be covered?

- Likely information timing:
  - GASB 67 numbers will have to be done in conjunction with the 6/30/13 valuation.
  - Consideration should be given to at least estimating the GASB 68 numbers at the same time to use in conjunction with the education effort necessary.
  - “Real” GASB 68 numbers will need to be done beginning with the 6/30/14 valuation to accommodate those employers who want to use BOY information in completing their CAFRs.