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Holding Government Accountable

Major Pension Financial Reporting Reform = Major Hit on Mendocino County

John G Dickerson

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The **Governmental Accounting Standards Board (GASB)** establishes the **rules state and local governments** must follow to prepare their **financial statements**. **Next summer** GASB intends to impose **huge changes** in how to **report pension finances**. Mendocino County would have to comply in 2013-14.

GASB has realized their **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**.

On 6/30/2010 Mendocino County's **Pension Fund** was **supposed to have $435 million**. It was **$135 million short**. Further the County still **owed $86 million on Pension Obligation Bonds** that were borrowed in 1996 and 2002 to eliminate earlier Pension deficits.

The County and its Pension Fund **achieved less than half** the County's **Pension Funding Requirements** over the past **2 decades**. The County still **owes $237 million** – **we aren't supposed to owe a dime**.

GASB's standards allowed the County of Mendocino to incur over **$200 million** of true **pension expenses** over the past 20 years it has **never reported to the public**.

The County operated with a real **average $10 million yearly deficit** over the past **2 decades**. Most officials and nearly all the people of Mendocino County **don't know it** because the County's **financial statements never reported** that true economic fact. That's **about to change** – big time.

If these new rules had been in place for Mendocino County's financial statements for June 30, 2010 **pension expenses** would have been reported as about **$50 million instead of the approximately $10 million** that was actually reported. Yearly Pension Expenses will be in the range of **$40 million to $60 million** for **at least 5 years** instead of the less than $10 million reported in the past. This will most likely force the County to report it's operating with an annual **deficit (loss) of around $25 million to $40 million** in those years.

Today unfunded pensions are only disclosed in footnotes – they aren't reported as liabilities. GASB will force Mendocino County to report a Net Pension Liability as an "official debt". That would have put a **$140 million Net Pension Liability** on the County's most recent Balance Sheet (June 30, 2010) - close to **doubling** reported total liabilities.

GASB proposed **a different procedure last year** that many analysts – myself included – believe is much more accurate. That method would have produced a Net Pension Liability of about **$380 million** – it would have **tripled** the County's reported total liabilities.

GASB has **no authority** to change **how and when** Mendocino County actually **funds pensions**. But they do define how governments must report their finances to the people. The **political impacts** of these changes in Mendocino County are likely to be **profound**. It remains to be seen what the impact will be on credit ratings, access to loans and credit, state requirements to operate with balanced budgets, etc.

GASB describes these proposals in three documents (***Accounting and Financial Reporting for Pensions, Financial Reporting for Pension Plans, and Pension Accounting and Financial Reporting – a Plain Language Description).*** To download copies go to: www.gasb.org/, then "Projects", then "Documents for Public Comment".

I've tried my best to interpret the complex proposals correctly but I wouldn't be surprised if I got something wrong. If you see an error **please let me know**.

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I take no position on what pension benefits should be.

I absolutely take the position that whatever they are their true expense and debt must be reported to the people and they must be properly funded which means they must not put huge debts on the backs of our kids.

I. KEY FINANCIAL DYNAMICS OF THE COUNTY'S PENSION FUND

Mendocino County's pension expenses don't happen when they are paid. That's the **payment of a debt.** The legal right to receive pensions is part of what the County "pays" employees while they are working. That's when the County's **real Pension Expense** happens - the **moment it incurs an obligation to make future pension payments.** By the time they retire employees have 100% earned their pensions and therefore 100% of the County's real pension expense for that employee has been incurred.[1]

A Pension Fund is **supposed to need only two sources of funds** – **yearly contributions** and **investment profits**. The **yearly contributions** are calculated so that – if all the dozens of assumptions and projections on which the calculation is based come true – there will be **enough money in the Fund in the future to pay the portion of future pension payments that are being earned that year**. These yearly contributions are the sum of the County's contribution (called the "Normal Contribution") and its employee's contribution.

Pension Funds should have enough money when employees retire to fully fund their pensions.

If all this happens, on average over the long term the County's **annual pension contribution** would in fact be its **true annual pension expense**, the Pension Fund would be **fully funded** over the years, and **all the pension expense related to retirees** will have been **reported** in financial statements **when they retire**.

But **no one knows while employees are still working the total amount of pensions they will receive** over their retirement. So – the amount of the **County's contribution** and **reported yearly pension expense** is an **estimate**. Because it's so **complicated** – the estimate is **always wrong**. The way it's **supposed to work** is that **necessary adjustments** will be made so that **over the long run** on average the **estimates will be close**.

If the County's Pension Fund develops a **serious deficit (unfunded pensions)** that means it's way short of the amount needed to pay future pensions that have already been earned. **ONLY the County is obligated** to make **additional payments to eliminate the deficit.** Employees have no such obligation.

If a Pension Fund experiences repeated significant Unfunded Pension Obligations something is wrong that needs to be "fixed". PERIOD! It almost always means real **Pension Expenses** in the past **were more than have been reported** in the County's financial statements**.**

II. GASB'S FATAL FLAW

The Fatal Flaw in GASB's current financial reporting standards isn't about when everything works according to plan – it's about **what happens when they don't**.

The Government Accounting Standards Board (GASB) now knows their current standards **allowed the County** to **report the pension expenses** that created well over **$200 million of unfunded pension debt** as if they will happen **in the future when the debt is paid over the next 30 years**. But they won't happen in the future – **they already happened in the past** when they **created the debt**. Those **$200 million of real past pension expenses have never been reported to the people**. That allowed the debt to develop "unseen", and therefore the people weren't able to hold County officials accountable.

[1] This is simply a statement of "Accrual Accounting". "Cash Accounting" generally waits until money moves to recognize income and expense. The Pension Expense would be reported when the Pension is paid – OR when the government makes a payment to its Pension Fund. "Accrual Accounting" is far more realistic. The "trigger" for reporting Pension Expense isn't when it's paid – it's when the obligation (debt) to make a payment is created.

III. Big Picture - What the New Standards Will Do

There are **two big changes** GASB will impose.

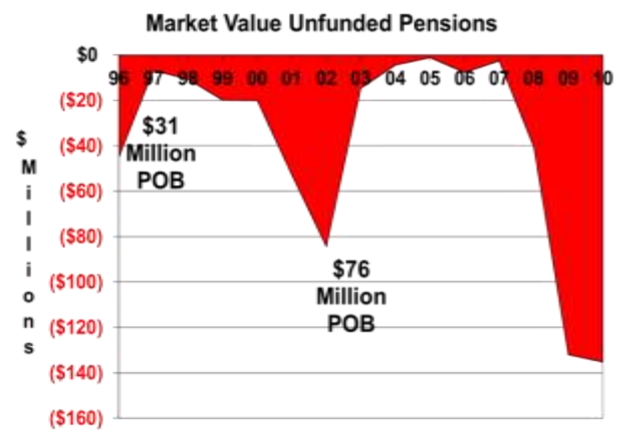
- Mendocino County will **no longer** be able to **spread reporting annual pension expenses** that **created unfunded pension debts 30 years into the future**. They're going to have to report them **on average within 5 years** or so!
- Today the County only put a footnote in their financial statements about how much unfunded pensions they owe. GASB will force them to list it as a **real liability on the County's Balance Sheets**, and the unfunded pension liability may be reported to be much bigger than the County discloses today.

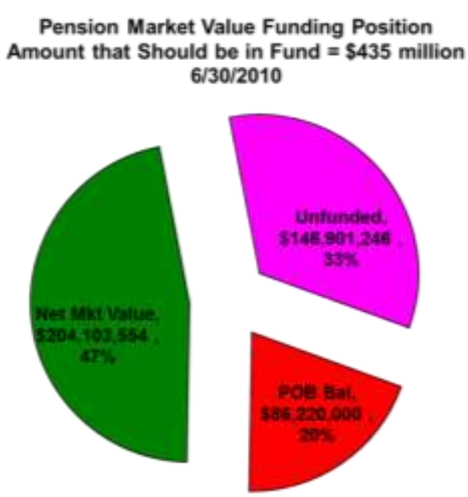
IV. Development of Mendocino County's Unfunded Pension deficits

1996: County develops $45 million of "Unfunded Pension Obligations" - borrows $31 million in "**Pension Obligation Bonds" ("POB").**

2002: County again develops Unfunded Pension Obligation, this time around $70 million. Borrows an additional $76 million by selling **more POB**.

2008 - 09: For the third time in 13 years the County again develops a significant Unfunded Pension Obligation $132 million as of June 30, 2009 and at least $140 million in 2010. This time the County elects to pay "**Unfunded Pension Amortization Payments**" to the Pension Fund instead of borrowing more money by selling POBs.





This shows the **financial status** of Mendocino County's **Pension Fund** as of June 30, 2010. As stated above**, if everything had worked** the way the **Pension Funding Plan** had predicted the Fund would have **been fully funded** and **no Unfunded Pension Debt** would have been created.

The Valuation for June 30, 2010 showed that the Pension Fund was **supposed to have $435 million** on that date. But it was **$135 million short**. Further the County **still** owed about $85 million on **Pension Obligation Bonds** that were borrowed in 1996 and 2002 to eliminate earlier Pension deficits.

The County and Pension Fund **achieved less than half the County's Pension Funding Requirements over the past 2 decades**.

The **County still owed $220 million** – **we aren't supposed to owe a dime**.

And here's the kicker – GASB's current standards allowed the County of Mendocino to incur at least **$200 million of true pension expenses over the past 20 years** it has **never reported to the people**.

The County – in true economic terms – has operated with about an **average $10 million yearly deficit** over the past **2 decades**. Most County officials and nearly all the people of Mendocino County don't know it because the County's financial statements **never reported that true economic fact**. This **wouldn't have happened if the County had been reporting the true economic pension expense** that was really occurring each year – which is what GASB now intends to require.

V. How Mendocino County Reports Pension Expenses Today

A. Normal Yearly Pension Expense

The Pension Fund's Actuary produces what's called an "**Actuarial Valuation**" every year. The Valuation always defines what's called the "**Normal County Contribution**" which is the amount the Actuary estimates the **County needs to contribute that year** so that **the part of future pensions that are being earned that year can be paid in the future** when they are due **assuming** the Pension Fund earns its target rate of return and all the dozens of other complex assumptions used in the Valuation come true. The **Normal Contribution** is always included in **each year's pension expense**.

B. Pension Expenses Related to Unfunded Pension Debt

When Mendocino County's Pension Fund developed the **three unfunded pension deficits** described above **only the County** was obligated to **pay more** to eliminate it. The County could have eliminated these deficits by making an immediate payment out of its reserves. But the County never had that much money sitting around. And so it chose to make payments over a number of years to eliminate the Deficits over time. There are two main methods to do this:

- **Pay Pension Deficit Amortization Payments**
- **Borrow Money by Selling Pension Obligation Bonds**

The County borrowed money by selling Pension Bonds to eliminate the first two pension deficits but elected to make unfunded pension amortization payments to eliminate the most recently developed deficit. I'll describe the amortization payments first, then the more complex Pension Bonds.

1. Unfunded Pension Deficit Amortization Payments

As of June 2010 the County's unfunded pension deficit was $135 million. This deficit developed over the previous two years. The County was obligated to begin making **unfunded pension amortization payments** in the fiscal year ending June 2011. Officials chose to amortize this deficit **over 30years**.

We aren't certain how the County will report the pension expense related to those payments because those financial statements haven't been released. In general it will **divide** an amount about **equal to the amortization payment** between **pension expense** and **interest expense**.

This will **make it appear** that the **pension expenses** tied to these unfunded pension deficit amortization payments **will happen as the unfunded pension deficit (debt) gets paid**. This is **utterly untrue**. All the pensions tied to the deficit were earned by employees in the past – that's when the expense really happened.

The **County intends to report those pension expenses that really happened before 2010 over the next 30 years** – long after many if not most of the people who actually earned those pensions have passed on.

That's bad enough. But Mendocino County's method of calculating these amortization payments goes beyond this "generic' problem and shows **several other aspects** of the **failure** of **current GASB standards**.

The County incurs an **interest expense** on the deficit's cash value equal to the Pension Fund's target rate of return of **8%**. That's because the County is expected to make up for "lost investment profits" caused by Pension Fund Deficits because the Fund doesn't have that money to invest and therefore can't earn 8% on that amount.

Because of a practice called "smoothing"[2] the County last year only had to start making amortization payments on about half of the real $135 million Pension Fund deficit. The County's amortization payments will increase each year as the part of the deficit that was "smoothed out" is slowly added back in over the following 4 years.

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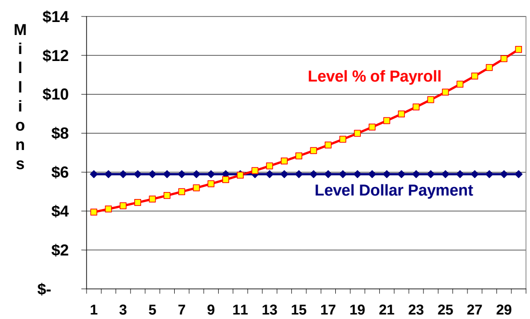
[2] See "Actuarial Value of Assets" in "How Mendocino County Reports Unfunded Pension Debt" on page 6.

Officials had a **choice of two methods** to calculate what the amortization payments would be.

- **<u>Level Payment</u>**: Just as with a "classic" 30 year home mortgage the County would pay the same amount each year. At the end of 30 years the UAAL would be eliminated.
- **<u>Level Percent of Payroll</u>**: First an assumed average rate of payroll growth over 30 years is established. That rate is used to project what total payroll will be in each of those 30 years. Finally the Actuary calculates a fixed percentage payment of each of those 30 yearly payrolls so that at the end of 30 years the UAAL would be eliminated.

This graph shows what the County's **deficit amortization payments** that started last year would be over 30 years under the two methods. The **Level Percent of Payroll** method **initially** produces **payments significantly lower** than the Level Dollar Payment method. But based on the assumption of 4% yearly growth in total payroll payments in the **later** years are **significantly higher**.



Mendocino County **officials chose the Level Percent of Payroll** method to eliminate the UAAL. I believe the **main reason** was the **much lower payments** in the first several years.

Payments are **so low** using the Level Percent of Payroll method they **don't even pay the 8% yearly interest** for **12 years**. **The County's payment in 2011** was **$1.7 million less than the interest** cost. Assuming all assumptions in the Actuarial Valuation "come true" unfunded pension **debt will actually increase** over the first 12 years. This is known as **Negative Amortization**[3].

Current GASB standards allow the County to **report** an amount **roughly** equal to **what was paid to reduce the pension deficit** each year as **part of that year's pension expense** – and amounts paid as **interest** as an **interest expense**. But how will the County deal with the fact that it paid significantly less than the total interest? Since the County hasn't yet produced audited annual financial statements for 2011 (the first year the County made Pension Deficit Amortization Payments) we don't yet know.

One thing is certain – once again the County is **reporting past pension expenses** that created the Unfunded Pension Deficit **as if they are expenses in the future** as the debt is paid rather than when they really happened in the past. In addition I believe the County **won't report that it incurred $1.7 million more interest expense during the year than it paid**, and will be allowed to omit that important information by today's standards.

2. <u>Mendocino County's Pension Obligation Bonds</u>

The County can also sell Pension Obligation Bonds (POB) to borrow money to eliminate the Unfunded Pension Deficit. This is **simply "restructuring" debt** by changing the unfunded pension deficit into Pension Bond debt. Once again current GASB standards allow the County to **defer reporting the pension expenses that caused the Unfunded Deficit over several decades in the future**. Only this time the accounting mechanism is **considerably more complicated**.

Mendocino County borrowed a total of **$110 million** by selling POBs in 1996 and 2002. The **balance** owed on those Bonds as of 6/30/2011 was **$86 million**. This was **half the County's reported debt**.

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[3] Mendocino County Retirement Officials claim they didn't realize this was happening – they claim they thought the payments were "taking care of the problem".

The County also reported an asset on its Balance Sheet titled "**Net Pension Asset**" valued at **$62.4 million** – nearly **30% of its total assets**. This is a "**Pre-paid Pension**" asset that was set up when the POB were sold to be **roughly equal to the amount of POB proceeds the County paid to the Pension Fund**.

The County's accounting entries in this regard are very **complicated** – but the "bottom line" is that instead of reporting that in fact past pension expenses were considerably more than had been reported in previous years, it essentially **"capitalized" those past pension expenses** by **reporting** the **payment of Bond proceeds to the Pension Fund** was a **payment of future pension expenses, not just the payment of a pension deficit** caused by past pension expenses.

Then – again using a complex accounting method – the County will **eliminate the value of that supposed pre-paid pension expense** asset over what will roughly be the **years it will take to pay the Pension Bonds**. It is showing the amount it reduces the pre-paid pension asset in a year **as part of that year's pension expense**.

Once again the **past real pension expense** that caused the Unfunded Pension Deficits is being **reported as an expense roughly over the same years the Bonds are being paid**.

But in addition the County's financial reporting related to its Pension Bonds brings up another **very serious problem**. The County created a "**Prepaid Pension" asset** roughly equal to the total unreported pension expenses of the past. This strikes me as a **huge violation of a fundamental accounting principle**.

What is an asset? Simple question. This is the definition of assets provided in one of the most important accounting textbooks in use today.

> *ASSETS: Assets are the economic resources of the entity, and include such items as cash, accounts receivable (amounts owed to a firm by its customers), inventories, land, buildings, equipment, and even intangible assets like patents and other legal rights and claims.* ***Assets are presumed to entail probable future economic benefits to the owner.***[4] *(emphasis added)*

That's **fundamental to the definition of an Asset** – it entails or provides a probable **future economic benefit** to the "owner" – in this case the County of Mendocino.

I**f the County had really "prepaid" $110 million of future pension expenses** that payment would have created an **asset**. It would have provided a **future economic benefit** because the County wouldn't have to pay pension contributions in the future as partial payment of the thing of value it would be receiving – the labor of its future employees.

But **that's not what this "asset" represents**. This "asset" is a **"ghost" of past pension expenses**. It's a **charade** – it pretends to be economically useful in the future as a "prepaid pension expense", but its **real function** is to **allow the County to report past expenses in the future**.

The "economic benefit" the County received is gone – it was the labor of its employees who earned pension payments in the past as part of their compensation in those past years. There is no more economic value to be derived for the County.

I believe this is a **"fake" asset** that is allowed to exist by today's deeply flawed GASB standards.

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[4] *Principles of Accounting*, from a "Preview of the new global edition" – Chapter 1 – Welcome to the World of Accounting, available at http://www.principlesofaccounting.com/chapter%201.htm, accessed on 7/26/2011.

VI. How Mendocino County Reports Unfunded Pension Debt

Under today's GASB standards Mendocino County **doesn't report a Pension Liability on its Balance Sheet**.[5] GASB requires the County to present three years of the financial position of its Pension Obligations as calculated by Actuaries in Actuarial Valuations in a form of **footnotes** called "**Required Supplementary Information**". This table was attached to the County's audited financial statements for fiscal year 2010.

This information is taken directly from Actuarial Valuations – it isn't not produced by Accountants.

Actuarially Accrued Liability (AAL): This is the amount the Actuary calculated **was needed to be in the Pension Fund** as of the "Valuation Dates" (shown in the table) so that the part of future pension payments that were already earned by employees in the past before the Valuation Date could be paid. There are several methods to use in performing these calculations – one of which is "Entry Age" as used in Mendocino County.

You need to understand "**financial discounting**" to understand how the Pension Liability is calculated and to realize the importance of one of GASB's reforms – using a lower "discount rate".

Assume you want $1 million 10 years from now. You can make a 10 year investment that will earn 8% a year. You need to invest about $464,000 today that will grow at 8% to be worth $1 million in 10 years.

The $1 million is called the "future value". The $464,000 is the "present value". The 8% is the "discount rate". This calculation is described as "discounting" the future value of $1 million by 8% a year for 10 years to produce the present value. It's said that the $1 million was "discounted" by 8% a year for 10 years.

COUNTY OF MENDOCINO

Required Supplementary Information
For the Year Ended June 30, 2010

SCHEDULE OF FUNDING PROGRESS – RETIREMENT PLAN

The table below shows a three-year analysis of the actuarial value of assets as a percentage of the actuarial accrued liability and the unfunded actuarial accrued liability as a percentage of the annual covered payroll as of June 30 (in thousands):

Valuation Date	Entry Age Actuarial Accrued Liability (AAL)	Actuarial Value of Assets	Unfunded/ (Overfunded) Liability (UAAL)	Funded Ratio	Annual Covered Payroll(1)	UAAL as a % of Payroll
6/30/08	$ 373,852	$ 353,421	$ 20,411	94.5%	$ 70,880	28.8%
6/30/09	403,196	336,263	66,933	83.4%	72,235	92.7%
6/30/10	434,987	343,202	91,785	78.9%	69,004	133.0%

(1) Plan members include the County of Mendocino, the Mendocino County Courts and the Russian River Cemetery District.

The Actuary **first projects for each year in the future how much will be paid as pensions that have already been earned in the past**. This projection will be many decades into the future. The Actuary then

[5] Pension Obligation Bonds are shown on the County's Balance Sheets as a liability. POB's almost always bear a lower interest rate than the Pension Fund's target rate of return that functions as the interest rate for unfunded pensions amortization payments. That's why the County used POB to borrow money. They've never explained why they didn't try to borrow more money for the most recent pension deficit.

"**discounts**" **that part of each year's future payments** using the Pension Fund's **target rate of return** as the **discount rate** (currently 8%) for the appropriate number of years to produce a **"present value" for each of those year's future payments**. The **total** of all those present values is the **Actuarially Accrued Liability** – or in other words the **Total Pension Liability**.

Two important things:

- **Only** the part of future pension payments that have **already been earned** are **discounted** to produce the **Total Pension Liability**. The part of future pension payments that will be **earned in the future** are **not included** in this calculation. The Total Pension Liability is **only about pensions that have already been earned** – and therefore was **totally created by true past pension expenses**.

- The **Total Pension Liability** is the **amount of money that is supposed to be in the Pension Fund today** so that if it grows at the target rate of return and all the other dozens of assumptions used by the Actuary "come true" then there will be enough money in the future to pay the part of those future pension payments that have already been earned by employees in the past. The **Total Pension Liability** is the "**net present value**" or "current value" of **that part of those future payments**.

(See page 8 for a discussion of GASB's proposed change in this procedure.)

Actuarial Value of Assets: In calculating the value of the Pension Fund's Assets Actuaries use a process called "**smoothing**". The Actuary "spreads" the amount the Fund was over or short of its target investment profits over a number of years. This produces a form of a "moving average" value of Pension Fund assets that is considerably less "volatile" than the actual Market Value of the Pension Fund's Assets. The purpose of Smoothing is to **avoid sudden precipitous increases in a government's UAAL Amortization Payments**. Mendocino County's Pension Fund spreads these "over-under" amounts over **five years** which is common among public Pension Funds although some use considerably longer Smoothing periods.

Underfunded/(Overfunded) Liability - Unfunded Actuarially Accrued Liability (UAAL): This is the smoothed Actuarial Value of Assets less the Actuarially Accrued Liability. If the resulting value is negative (a Deficit) It's what the Actuarial Valuation indicates is the **amount of money that should be in the Pension Fund but isn't.** The **County** is **solely responsible** to **pay additional money** on top of its Normal (Yearly) Contribution to eliminate this value.

Note – the table shown above is all that's in the Supplemental Information – there is no explanation of what the terms mean, how they are calculated, and how readers should understand them in terms of the County's financial condition. Very few people would understand this table without that explanation – which the County doesn't provide.

VII. Changes to be Imposed on Mendocino County by GASB

A. Severing Financial Reporting from Actuarial Valuations

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 extremely important concerns in financial reporting.

That's not the way Actuaries think. They think in terms of decades in the future.

The **Fatal Flaw** GASB made described at the beginning of this paper was **created because** when **GASB** issued their current standards 20 years ago they **made their standards conform** to **how Actuaries calculate and plan the funding of pensions**.

The **most fundamental change** GASB is making is **<u>severing accounting rules</u> from how Actuaries plan the funding of Pension Funds**.

Actuaries are concerned about **cash flow** – cash into the Pension Fund and cash out. Large unfunded pension deficits often appear suddenly as a result of steep declines in the stock market (and other investment markets). Actuaries have developed methods to **prevent** such steep declines from causing **sudden precipitous increases in the government's required Unfunded Pension Amortization payments**. They do this in order to soften the destructive and chaotic impact such steep increases would have on government yearly budgets. They slowly "ramp up" the amortization payments over a few years in the hope that government revenues would increase to help make the higher payments without cutting services, or the Pension Fund will eliminate some or all the unfunded pension deficit by over-target returns on investments, or to provide the government with a few years to more calmly reduce its operating budget to make room for increased debt payments – or a combination of all three.

They also **allow governments up to 30 years to eliminate unfunded pension deficits**.

Actuaries are **primarily focused** on making sure a government's **pensions can be paid when due decades in the future**. Subject to that goal they try to make the funding as "easy" as possible on the government. They **aren't focused** on reporting what's happening today to the **"true economic" pension expense and debt**.

Actuarial goals – in turns out – when **translated into accounting rules** wound up **greatly damaging** the **long-run financial viability** of **Pension Funds** and thereby the **financial integrity of the governments** responsible for providing pensions. That's because **government officials were not confronted as soon as possible** with the fact that their **pensions** were truly **costing far more than they thought**. And – therefore – government officials **put off dealing with the problem for decades** – and the debt problem slowly got **worse and worse**.

B. <u>Pension Expenses</u>

GASB's reformed standards would impose a **much more complex method** to calculate Pension Expenses than that used today. However, it would also be **far more economically accurate**.

Because Mendocino County has a very **significant Unfunded Pension** Debt (including its Pension Bonds) **when these standards will be implemented** it will experience a **very substantial immediate increase** in its **reported yearly Pension Expense**.

Pension Expenses were **reported as $9 million to $13 million** in the County's **2010** financial statements (depending on which schedule you looked at). They **would have been around $50 million** under the new standards**.** This is a huge hit since total operating expenses were reported to be about $181 million.

Today the County reports as its yearly **pension expense** the amount the Actuary calculates as the County's **Normal (Yearly) Contribution plus** an amount **roughly** equal to the part of **unfunded pension deficit amortization payments** that reduce the deficit and the **amount the pre-paid pension asset related to Pension Bonds is reduced** each year.

GASB refers to the Normal Contribution as the Current Period (Year) Service Cost. It will be a part of the calculation of Pension Expense after GASB's new rules take effect.

However, **pension deficit amortization payments** will be **no longer part of the calculation of a year's Pension Expense**. **Nor** will **reductions** in the value of a **"prepaid pension" asset related to Pension Bonds**.

Significant Stock Market Losses in 2008 & 2009: Mendocino County's Pension Fund was about **$140 million below its target investment earnings** during the stock market "crash" in 2008 and 2009. Today those deficits are being **"smoothed" over 5 years**. **Then**, as those earnings deficits reduce the value of Pension assets over those five years the County starts paying its **unfunded pension deficit amortization**

payments which will extend over **30 years** (see page 3). Current practice is to allow the County to report the underlying Pension Expense related to the Pension Deficit that really happened in the past over the next 30 years. Therefore the County – as things stand today – wouldn't finish reporting all these past pension expenses for 35 years!

These new standards would require the County to include the effect of those earnings deficiencies within five years from when they happened. Since the County will have to implement these new standards in its fiscal year 2013-2014 financial statements (under the current proposal) the total negative impact of **stock losses in 2008 & 2009 will be included in the County's reported Pension Expense and Debt by 2014**. And – the County will have to **restate its financial statements for the previous 6 years or so** to show the much greater pension expenses the new standards would have reported in those years.

Must Faster Reporting of Pension Expenses: **Today** the County is allowed to spread reporting the pension expenses of the past that caused Unfunded Pension Deficits over **30 years** or so in the future. The **new standards** will require **significantly faster** reporting – I figure an **average of around 5 years**.

C. Pension Liabilities

There are two big changes -

- A "Net Pension Liability" will be **listed as a Liability** on the County's Balance Sheet instead of in a form of a footnote attached to the financial statements.
- The **unfunded portion** will be valued by using a **lower discount rate** (a high-quality Municipal Bond index rate – about 4.5%) rather than the Pension Fund's target rate of return of 8%.

The system GASB defines in its **current Proposed Standards** is somewhat **complicated**. It would produce a **reportable Net Pension Liability roughly equal** to the amount defined by the Pension Fund's Actuary as the "**Unfunded Actuarially Accrued Liability**". That would have put a **Net Pension Liability** of about **$140 million** on the County's **June 30, 2010** **Balance Sheet** which would come close to **doubling reported total liabilities.**

Many analysts – myself included – prefer a **method GASB proposed last year**. That method would have reported about **$380 million of Unfunded Pension Liability**. **Reported total liabilities** would have **tripled** under last year's proposed system.