

September 27, 2011

Director of Research and Technical Activities  
Governmental Accounting Standards Board  
Project No. 34-E & 34-P  
Norwalk, CT 06856

Mr. Bean and Team:

I'm coming from a very different perspective compared to most others who have commented on GASB's proposed pension reporting standards.

I live in Mendocino County - two hours north of the Golden Gate on California's North Coast. Ours is the most indebted County per capita in California. Unfunded pensions made it so.

I had grown increasingly concerned about my home County's finances over several years. Then the "official" explanations of budget cuts imposed by the County in 2003-04 didn't "add up" to me. I sensed something big was wrong but nobody was saying what it was.

I have a great deal of education and experience in accounting, financial management and analysis in the private sector, but no previous experience in governmental or pension financial reporting and analysis before I started digging into our County's finances. I had no idea of the morass of bad news I would find.

I'm speaking as a private-sector financial professional and deeply concerned citizen to all you government financial pros - the single biggest shock I experienced in analyzing my County's finances (I was literally "speechless") was the day I suddenly realized my County had really and truly incurred hundreds of millions of past retiree benefit expenses that it hadn't reported in financial statements. I was astonished when I realized the County had "capitalized" the pension expenses that created unfunded pensions that were eliminated by proceeds of Pension Obligation Bonds. (Governments send us private sector types to jail for doing that, don't they?)

Today's GASB standards produce financial statements that tell us that future pension expenses created today's unfunded pension debt. That's absurd. Past pension expenses created today's debt. All across America hugely destructive financial behavior was not identified and therefore continued for decades.

A defense of current standards is a defense for this continuing to happen.

The proposed GASB standards will go a long way to help prevent the financial damage done to my County and thousands of other local governments from happening in the future. I thank GASB for producing these very important reforms, and for being willing to stand up for the Matching Principle despite the resistance of those who prefer to maintain the cash-basis status quo. I wish your predecessors two decades ago had done so; hundreds of billions of debt would have been avoided.

/s/ John G Dickerson  
YourPublicMoney.com

PS - Purely as a comment on the structure of your documents, I found myself "lost" several times regarding where in the hierarchy of topics I was. Your Table of Contents is nicely organized by indentations indicating the hierarchy. But when I got into the text I several times got lost. Some "titles" are italicized, some aren't. Some are bold, some aren't. Some are underlined, some aren't. I was most "lost" in the transition from "Single and Agent Employers" and "Cost-Sharing Employers". I think if you used a numeric-outline system (as I have below) it would help readers (or at least me) keep track of where they are.

# Table of Contents

<b>I. PUBLIC ACCOUNTABILITY AND GASB – CONCERNS, PERSPECTIVE, CONTEXT .....</b>	<b>1</b>
<b>II. MENDOCINO COUNTY – A WORST CASE EXAMPLE OF PENSION DEBT .....</b>	<b>1</b>
<b>III. GASB’S PROPOSED REFORMS ARE ABSOLUTELY ESSENTIAL .....</b>	<b>2</b>
<b>IV. MY MAJOR CONCERNS WITH THE PROPOSED GASB STANDARDS .....</b>	<b>2</b>
A. DETERMINATION OF THE DISCOUNT RATE .....	2
1. <i>Problems</i> .....	2
a) Too Complex.....	2
b) The “Problem” isn’t only Deficient Employer Contributions .....	3
c) The Marginal Net Present Cost of Future Diminished Services to the People .....	4
d) Who Is Taking the Risk? .....	5
2. <i>Proposed Discount Rate Method = Girard Miller</i> .....	6
B. TRANSITION AND RESTATEMENT OF PRIOR YEAR STATEMENTS .....	6
1. <i>How Far Back?</i> .....	6
2. <i>“Practical” or “Avoidance of Accountability”?</i> .....	6
3. <i>Explanation to Citizens</i> .....	7
C. USE OF PENSION FUNDS TO PAY OTHER BENEFITS (RETIREE HEALTHCARE).....	7
<b>V. COUNTY (EMPLOYER) FINANCIAL REPORTING .....</b>	<b>7</b>
A. WOULD GASB’S NEW RULES HAVE IDENTIFIED THE CAUSES OF THE NET PENSION DEBT? .....	7
1. <i>Deficient Pension Fund Investment Earnings</i> .....	7
2. <i>Diversion of Pension Funds to Pay Retiree Healthcare</i> .....	8
a) 1937 County Employees Retirement Act (“1937 Act”) .....	8
b) What “Excess Earnings”? .....	9
c) County Reporting .....	9
d) Retirement Association Reporting.....	9
e) GASB’s Proposed Standards Are Significantly Deficient .....	10
3. <i>Less Significant Causes of Mendocino County’s Pension Debt</i> .....	11
a) Unfunded Retroactive Increase of Pension Benefits. ....	11
b) Disability Retirement Rates Significantly Higher than Actuarial Assumption .....	11
c) Greater than Assumed Growth of Total Salaries .....	11
d) Deficient Contributions .....	11
B. OTHER ISSUES ABOUT EMPLOYER REPORTING .....	11
1. <i>Employer Contributions</i> .....	11
a) Normal Yearly v. UAAL Amortization Payments .....	11
b) Amounts paid by employer on behalf of employees.....	12
2. <i>Add UAAL Payments to Schedule of Long-Term Liabilities</i> .....	13
3. <i>Cost Sharing Plans</i> .....	14
4. <i>Pension Obligation Bonds</i> .....	15
5. <i>Picky Details</i> .....	16
a) Interest on Beginning Net Pension Liability or Average Net Liability?.....	16
b) Remaining Service Lives.....	16
c) Discount Rate Sensitivity .....	16
<b>VI. PENSION FUND FINANCIAL REPORTING .....</b>	<b>16</b>

## I. PUBLIC ACCOUNTABILITY AND GASB – CONCERNS, PERSPECTIVE, CONTEXT

My primary concern with GASB's proposed pension financial reporting standards is the ability of concerned citizens to use financial statements to understand the important financial "truths" of their local governments so they can hold officials financially accountable.

My perspective is that of a concerned citizen with a great deal of education and experience in accounting, financial management and analysis in the private sector, but no previous experience in governmental or pension financial reporting and analysis before I started analyzing the finances of my County seven years ago because I sensed something was very wrong.

My experience in the past 7 years is primarily related to the 21 County Retirement Systems in California that do not participate in CalPERS – they have their own separate independent retirement systems. I've learned a great deal about how these independent County systems "work" and feel professionally comfortable commenting about GASB's ED's in that arena. Although many of these county systems have smaller sponsoring local governments participating, in effect they operate as Single Employer Pension Plans. I don't know enough about the complexities of the large statewide retirement systems to venture onto that ground.

The County's financial statements – and those of the Mendocino County Employees Retirement Association (MCERA) – were significant barriers to my understanding my county's finances. Because of my training and experience, and motivation, I was able eventually to "penetrate" those statements – although significant frustrations remain. But even with my background it took many hundreds of hours to do so. I had to learn far more about governmental accounting and reporting and dig much deeper than I think should be required.

My County provides a clear case study of what can go wrong – including but not limited to the severe negative impact of GASB's current standards. And it provides a context for thinking about what prevents concerned citizens from effectively using financial statements to hold local government officials accountable.

I'm placing my comments about GASB's proposed standards in the context of my efforts to understand my County's finances. Because of this approach this paper is longer than the other Comment Letters GASB has received. Sorry. But I'm showing in a specific case study how GASB's current standards are complicit in the great financial damage that's been done, how GASB's proposed reforms will greatly help, where I feel they are deficient (in one aspect seriously so), and why I offer a few suggestions.

## II. MENDOCINO COUNTY – A WORST CASE EXAMPLE OF PENSION DEBT

Based on the most recent data (2009) in the California State Controller's Office (SCO) *Counties Annual Report*<sup>i</sup> (see end note for data issues) compared to all other California Counties, Mendocino County had per resident the highest long term debt, the highest annual payments on debt, and the highest interest expense

In terms of the percentage of its property tax income consumed by debt Mendocino County had the highest percentage consumed by interest expense and the second highest consumed by annual debt payments. In terms of the percentage of total expenditures consumed by debt, Mendocino had the highest percentage consumed by interest and the highest consumed by total debt payments.

We enjoy this dubious distinction because of our County's unfunded pension debt.

We have a small population (88,000 residents) in a rugged mountainous heavily forested County three times the size of Rhode Island. The County's planned expenditures this year are \$220 million. General Fund expenditures will be \$150 million, of which \$50 million is considered the "Discretionary General Fund".

Eighty five percent of our County's \$267 million debt as of June 2010 was created by unfunded pensions. If the County hadn't abrogated its obligations for its \$135 million unfunded retiree healthcare obligation our debt would have been \$400 million.

The County developed a \$45 million "Unfunded Pension Obligation" in 1996. It borrowed \$31 million by selling "Pension Obligation Bonds" ("POB") to eliminate most of it. In 2002 the County developed another

Unfunded Pension Obligation, this time around \$70 million. It borrowed an additional \$76 million by selling more POB. In 2008-09 for the third time in 13 years the County developed a significant Unfunded Pension Obligation - \$132 million as of June 30, 2009. This time they elected to pay UAAL amortization payments because I and 100 other fired up leading citizens from across the political spectrum demanded they reform their financial management before they borrow any more money.

County officials have never requested a report to find out why this keeps happening. And the County's and Retirement Association's financial statements provide them essentially with no help in understanding what caused this debt and what needs to be done to stop creating more.

County officials assured the citizenry they had produced "balanced budgets" for decades – and still do. The only reason they are able to make that claim is deeply flawed budgeting and financial reporting requirements. GASB standards allowed them to defer decades into the future reporting the hundreds of millions of true past retirement expenses that created the County's unfunded pension debt. The state-imposed County Budget system – the only comprehensive financial planning system in the County – is a one year cash flow plan. The County's (and State's) definition of a balanced budget is basically "available cash = expenditures". In practical terms the system completely ignores the accruing expenses that create unfunded retiree benefit debts.

### III. GASB'S PROPOSED REFORMS ARE ABSOLUTELY ESSENTIAL

Although I have some concerns I strongly support GASB's two proposed central reforms:

- **Much Faster and "Actionable" 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 new rules will force them to report those past expenses within an average of around 3 to 7 years or so – depending on what specifically is causing the unfunded Pension Fund Deficit. Further the new rules will require governments to report specific causes of unfunded pension debt instead of simply reporting "generic" pension expense in the future. This will focus attention on where the problems lie.
- **Unfunded Pensions Listed as Balance Sheet Liabilities:** Today unfunded pensions are disclosed in a form of notes attached to financial statements. After these new rules take effect they will be listed directly on government Balance Sheets as debt, which they are.

These core reforms must be maintained in the final standards to be released next summer. Even if there were no changes to the current proposals, they are a huge improvement over the current standards.

### IV. MY MAJOR CONCERNS WITH THE PROPOSED GASB STANDARDS

#### A. DETERMINATION OF THE DISCOUNT RATE

I have several problems with the method regarding the discount rate proposed in paragraphs 22 through 25.

##### 1. Problems

###### a) Too Complex

Occam's Razor: "Of two explanations, all other things being equal, the simpler is preferred."

The financial and actuarial math of defined retirement benefits is unavoidably very complicated. Few – if any – members of the governing bodies of counties and cities I've observed understand it. Very few "normal" concerned citizens understand it. This complexity by itself is a major cause of the major unfunded pension debt in thousands of local governments. How can officials manage their finances and citizens hold officials accountable if hardly anyone understands how defined pensions really work?

GASB's proposed fundamental reforms must be accomplished. Subject to that (and other objectives I'll discuss below) I encourage GASB to apply Occam's Razor – in general make its rules as simple as possible. There's no

way to eliminate the essential complexity of the actuarial and financial math of defined pension benefits, but if possible GASB should not compound that problem.

I believe the method proposed regarding the “trigger” that switches the discount rate from the target rate of return to a lower rate doesn’t serve to clarify – it will confuse and allow obfuscation.

### b) The “Problem” isn’t only Deficient Employer Contributions

If I understand the proposed method the only “trigger” that will bring in the lower discount rate is a government’s practice of not paying their full contributions as defined in Actuarial Valuations. Those that have very significant unfunded pension debt and yet provide the specified contribution today won’t trigger the lower rate because projected UAAL Amortization payments by definition eliminate the debt.

Mendocino County shows what I believe is a major flaw in that logic.

Twenty one California counties don’t participate in CalPERS; they have their own “independent” Pension Funds. According to State Controller data (*Annual Public Retirement Systems Report*) during the 13 years from 1996 through 2008 the average target rate of return for all 21 systems was 8.02%. The highest average target rate over those years was 8.23% (San Diego) and the lowest was 7.54% (San Luis Obispo).



This graph shows for those 21 Pension Funds the percentage above or below their average target rate of return from 1996 through 2008.

For example, MCERA’s average target rate was 8.0%. It achieved 6.99%, which was 12.6% short of its target.

According to Mendocino’s Pension Fund’s Actuarial

Valuation for June 30, 2010 the Fund’s 14 year compounded average return for 1997 through 2010 was 5.2% - one-third below its target rate.

The failure of Mendocino County’s Pension Fund to achieve its target rate of return created about \$100 million of unfunded pensions over those years and is by far the largest source of Mendocino County’s debt.

Mendocino County has contributed what it’s supposed to in recent years. If I understand GASB’s proposed “trigger” Mendocino’s Pension Fund wouldn’t pull that trigger. Its assumed rate of 8% would be used.

But Mendocino’s Pension Fund has been significantly below that target rate of return for an extended period of time. For Pension Funds that chronically underperform I believe GASB’s proposed cash flow projection method would seriously underestimate the most probable UAAL amortization payments – and hence seriously understate the implicit risk posed by the Pension Fund to the people.

I realize I’m focusing on one of 21 counties and that 19 of them appear to have achieved returns greater than their target. However, that one county is my county and why shouldn’t I expect that GASB’s rules will make my county’s financial statements convey a true picture of its prospects and financial performance?

Another example – the County increased its workforce nearly 40% from 1997 through 2002. On top of that, it increased its average salaries 35% from 2000 through 2004. The net result was that the County’s total salaries nearly doubled from \$28.3 million in 1996 to \$53.3 million in 2003.

During that time the County told its Actuary that its total salaries would increase by 5.75% a year. Instead, they grew at nearly twice that rate. The result was that the annual pension expense calculated by the Actuary and set aside in the Pension Fund was significantly too low.

County officials saw the growth in their total salary – as did the Retirement Administrator. And they saw the actuarial assumption in that regard. No one in those 7 years corrected the assumption.

If the failure to contribute the required contribution as defined in Actuarial Valuations is cause to trigger the lower discount rate, why shouldn't the significant failure to achieve the target rate of return or the pattern of behavior in which a government expands total salaries much faster than it tells the Actuary to assume do so?

The very existence of a net pension liability is on its face proof that a government Pension Fund did not achieve its pension funding plan objectives as stated in its Actuarial Valuations (assuming the goal of those Valuations is a fully funded Pension Fund). Why should GASB's "trigger" be only one of the dozens of ways a Pension Fund can fail to meet its funding requirements?

You could say the difference is that if the government is contributing less than it was told by the Actuary that it should, then that behavior is purposeful which sets it apart from other causes of unfunded pensions. But that's clearly a refutable assertion. Governments can purposefully understate the growth of its salaries and staff. The Retirement Association can be satisfied with poor investment performance because it knows the government is obligated to pay pensions no matter what (which I'm convinced happened in my County). There are several patterns of purposeful behavior that create net pension liability. Why elevate only one to be the "trigger"?

### c) The Marginal Net Present Cost of Future Diminished Services to the People

Part of paragraph 126 of the proposed new standards reads:

*... one of the effects of the longevity of governments on accounting and financial reporting is that accounting information is used not to answer questions about whether governments will continue to exist but rather for **insight into "the sustainability of the level of services provided and the ability to meet future levels of demand for services."** (Emphasis added)*

I believe the issue of what discount rate to use should be settled by the impact it will have on the long-term sustainability of government services which translates into the well-being of the people – not based on a career-long relationship between the employer government and its employees.

In simple terms if governments are faced with a significant Unfunded Actuarially Accrued Pension Liability (UAAL) they have to take steps to eliminate it. They have three choices.

- Pay it off out of their cash reserves (fat chance!)
- Pay UAAL amortization payments above and beyond their "normal" yearly contributions.
- Borrow the money usually by selling Pension Obligation Bonds (POB).

Assume a government has a \$1 million net pension liability. It will pay that debt over 15 years with equal payments at the end of each year. Further assume the government and its Pension Fund will precisely execute the pension funding plan as stated in the Fund's Actuarial Valuations (the Fund will earn its target rate of return of, say, 8% each year, all actuarial projections come true, etc.).

Then assume 2 cases. In the first case the government chooses to make unfunded pension amortization payments to the Pension Fund. In the second case the government decides to borrow money to eliminate the net pension liability immediately and pays an interest rate of 4%. (Don't consider transaction costs, etc.)

	Amortization Payments	Borrow the Money
Yearly Payments	\$116,830	\$89,941
Total Payments	1,752,433	1,349,117
Total Interest	752,433	349,117

The government's decision to pay unfunded pension amortization payments to the Pension Fund will cost its people \$403,327 more over those 15 years than if it had borrowed the money. And – the government will not be able to provide the services that amount of money would have produced for the people over 15 years.



The net present value of the yearly difference in payments (\$26,888 for 15 years) discounted by 4% is \$298,956. **I submit that's the marginal net present cost of future diminished services to the people if the government makes amortization payments instead of borrowing money.**

I perceive a fundamental contradiction between the general principle stated in paragraph 126 and the justification of the use of the target rate of return in paragraph 181. Which is “more important” – the sustainability of services and the level of services that can be provided to the people in the future – or the long-term relationship between the government and its employees in the context of their pensions?

My vote is for the effect on the people in the future.

I believe a lower discount rate that approximates the interest rate the government would pay if it borrowed the money more correctly evaluates the present cost of the loss of sustainability of services and the reduced level of services in the future resulting from the government's decision to pay amortization payments.

Most of the arguments I've read that support the use of a lower discount rate are along the lines expressed in the Stanford Institute for Economic Policy Research policy brief titled Going for Broke: Reforming California's Public Employee Pension Systems dated April 2010:

*Financial liabilities have to be discounted at the rate that most accurately reflects their inherent risk. What is the risk associated with public pensions in California? California law affirms vested public pensions are a form of deferred compensation and cannot be reduced: “A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity.”(Quoted from Betts vs. Board of Administration (1978) 21 Cal.3d 859). Since pension liabilities are effectively riskless, we believe they should be discounted and reported at risk-free rates.*

While I agree - that's not my argument. My argument here is that when a government chooses to eliminate a net pension liability through amortization payments to the Pension Fund the real present cost of reduced future services is significantly greater than the result obtained by borrowing money to eliminate the net pension liability and incurring a lower interest rate. The critical issue is today's cost of future reduced services.

#### **d) Who Is Taking the Risk?**

I haven't worked out a mathematical explanation or justification for this concern. However I feel it's the most important reason a lower discount rate should be used to discount the unfunded portion of future pension payments to determine the value of the net pension liability.

When we talk about risk – who really is incurring the greatest risk related to today's unfunded pensions? It isn't you and me - the generations that are today determining what GASB's standards will be. It isn't those of us “of a certain age” who are likely to not be around if the net pension liabilities really hit the fan.

To the extent the legal guarantee is sustained that pensions earned by government employees must be paid, the employees and retirees are not taking the greatest risk. HOWEVER – today's government employees are definitely at risk. As Thomas Jefferson said “the earth belongs to the living”. He meant that the arrangements made by previous generations to govern their lives are not necessarily binding on following generations. If something established by a previous generation becomes significantly destructive of the people's welfare they have a right to change or abolish it. The more that future payments of unfunded pensions destroy government services the more likely future voters and government officials will act to reduce existing pension obligations.

I think the people who are taking the greatest risk related to today's net pension liabilities are young people and people who aren't even born yet. I believe “our” generations have imposed a hugely unfair unfunded pension burden on young people and future generations. We have deeply violated “intergenerational equity”. They are the ones who are most at risk but they essentially have no voice to influence our decisions.

If a lower discount rate is used higher values of the net pension liability would be reported. That would probably lead to fewer state and local government employees and more constrained compensation. But it would also produce much stronger Pension Funds far less likely to impose today's costs on the future.

I feel the most powerful argument for a lower discount rate when unfunded pension obligations exist and resulting higher values for net pension liabilities is we should not impose unfair financial burdens on the young and future generations. We should impose the discipline on ourselves that would result from the use of a lower discount rate. We should do that most of all in the interest of young people and those who will be born in the next 20 to 30 years – to reduce the risk we are imposing on them.

## **2. Proposed Discount Rate Method = Girard Miller**

I support the method proposed by Girard Miller in his “Letter of Comment No. 1” dated 7/20/11.

- It’s simple – it doesn’t compound the confusion inherent in the complex math of defined benefit pensions. It greatly reduces the possibility of “gaming” and “official obfuscation”.
- It doesn’t single out just one of dozens of reasons a Pension Fund can be underfunded as the “trigger” that determines when a lower discount rate would be used.
- It more accurately describes the present value of reduced future services that results from the decision to eliminate net pension liabilities through amortization payments to the Pension Fund rather than to borrow the money.
- It better protects future generations.

## **B. TRANSITION AND RESTATEMENT OF PRIOR YEAR STATEMENTS**

Paragraph 108 states:

*To the extent practical, accounting changes made to comply with this Statement should be reported as adjustments of prior periods, and financial statements presented for the periods affected should be restated. It may not be practical for some governments to determine the amounts of deferred inflows of resources and deferred outflows of resources, as applicable, at the beginning of the period when the provisions of this Statement are adopted. In such circumstances, beginning balances for deferred inflows of resources and deferred outflows of resources should not be reported. If restatement of all prior periods presented is not practical, the cumulative effect of applying this Statement, if any, should be reported as a restatement of beginning net position for the earliest period restated. In the period this Statement is first applied, the financial statements should disclose the nature of any restatement and its effect, including whether the restatement of beginning balances included deferred inflows of resources or deferred outflows of resources, as applicable. Also, the reason for not restating prior periods presented should be explained.*

### **1. How Far Back?**

As it relates to current staff, reporting the effect of differences between expected and actual experience re economic or demographic factors and the effects of changes in economic or demographic assumptions are to be spread out over the weighted average expected remaining service lives of current staff – which I understand is thought to be typically in the 12 to 15 year range.

Does that mean that if it’s “practical” for a government to restate prior period statements to reflect changes in this part of the standard –they would be expected to produce statements back to the average remaining service lives of the staff that existed at the time these changes occurred? Could that be up to 15 years?

If so – that seems excessive. I’d think 5 years would do.

And – I assume that if prior year statements are restated they will appear in the footnotes of the statements produced during the transition year – is that correct?

### **2. “Practical” or “Avoidance of Accountability”?**

There are government officials who will consider it impractical to restate prior year statements because it would make them look bad. Who decides whether or not it’s practical, and by what standards? This seems pretty vague and allows a lot of “wobble room” for officials who really should and could restate prior year statements because the people ought to see what really happened to their government.

I believe this proposed standard is far too vague and there should be much more firm guidance.



### **3. Explanation to Citizens**

My greatest priority is that concerned citizens need to understand their local government's financial statements so they can hold their local officials accountable. These proposed standards would have very significant effects on the financial statements of thousands of local governments. I believe concerned citizens need 1) a very clear simple explanation of the purpose and nature of these new standards, and 2) a clear statement of the total amount of pension expenses that were recognized as a result of the transition.

That information needs to be in the same place – not scattered through the Audit Report package.

A very large number of local governments have run up relatively huge net pension liabilities that are going to very seriously reduce public services for many years into the future. Very significant unreported pension expenses will be “flushed out” of their hiding places by the transition to the new standards.

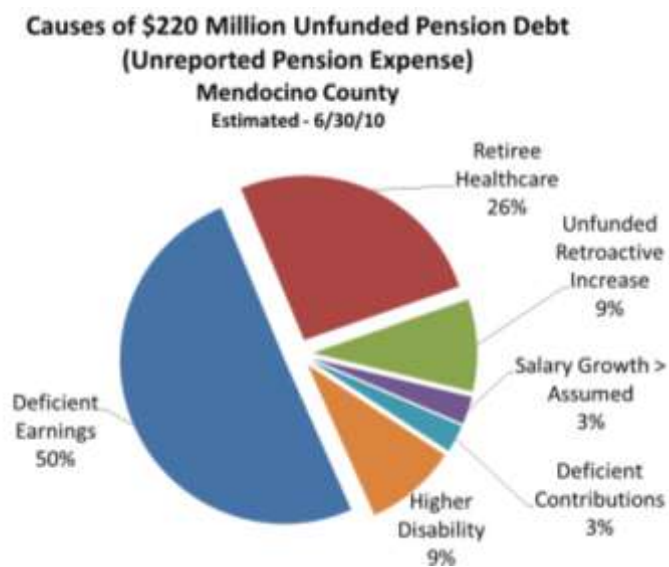
Concerned citizens of such governments need to see – in black and white - the numeric value of those past pension expenses that are essentially “being expensed” in the transition year. Bluntly speaking –citizens of thousands of local governments need to be told that had these new rules been in effect their local governments would have reported significant operating deficits in their Statement of Changes of Net Assets and significantly higher debt for many years in the past. The people need to know that fact. A simple adjustment of Net Assets on the Balance Sheet won't do.

### **C. USE OF PENSION FUNDS TO PAY OTHER BENEFITS (RETIREE HEALTHCARE)**

I lay this problem out in “**Diversion of Pension Funds to Pay Retiree Healthcare**) on page 8.

## **V. COUNTY (EMPLOYER) FINANCIAL REPORTING**

### **A. WOULD GASB'S NEW RULES HAVE IDENTIFIED THE CAUSES OF THE NET PENSION DEBT?**



Mendocino County officials have not produced or analyzed a report quantifying the causes of this debt. How can they fix a problem if they don't know what it is? I believe several of the changes in the proposed amendment to GASB 27 will go a very long-way to correcting this huge omission, such as the tables illustrated on pages 119, 120, and 122.

This graph shows my analysis of the causes of the County's unfunded pension debt.

Would GASB's proposals have caused the County to report these causes of its unfunded pension debt in a way that would clearly identify the problem to concerned citizens and to County officials?

### **1. Deficient Pension Fund Investment Earnings**

This is – by far – the largest cause of my County's unfunded pension debt.

GASB's proposed standards identify two numbers that give information about this cause of unfunded pensions – “Interest on the Total Pension Liability” and “Net Investment Income”. If I understand GASB's proposals correctly, I have two issues. First, they don't require an explicit calculation to show citizens whether or not earnings were less than the accrued interest – although it is very easy a reader to make that calculation.

More significantly the numbers blur the distinction between two possible causes of deficient earnings:

- The Pension Fund didn't achieve its target rate of return.
- The Pension Fund is underfunded.

My experience indicates this distinction is significant in understanding what the problem is. For years County officials said when the Pension Fund earned more than its target rate of return that things were great without realizing the problem created because it can't earn investment returns on money it doesn't have.

To illustrate this issue, assume a Pension Fund has a Total Pension Liability of \$100 million and a target rate of return (and hence an interest rate) of 8%. Therefore the yearly interest charge is \$8 million. (Disregard for this illustration concerns about fluctuating values of Total Pension Liability and Total Assets during the year.)

Let's say it actually has \$66 2/3 million in assets. And assume it earns \$6 2/3 million as its net ROI.

On the one hand it's \$1 1/3 million short of the interest charge of \$8 million – and that's bad. On the other hand if it had only earned its target rate of return of 8% on the assets it actually had it would have earned \$5 1/3 million. Instead it actually achieved a 10% net ROI which produced \$1 1/3 million more than if it had achieved its target net ROI rate. That's good.

The distinction will often be important in understanding what the problem is.

If we simply look at the difference between the Interest on Total Pension Liability and the net ROI the probable conclusion most people would reach is “the Pension Fund isn't earning what it's supposed to.” But if we also see that in fact the Fund earned 10% instead of 8%, the probably conclusion becomes “the Pension Fund is earning more than its target rate but it doesn't have enough money”.

There's a huge difference between those two conclusions. And the sponsoring government and concerned citizens need to understand that difference.

Because the impact of earnings variances has such a significant impact, I suggest GASB require an additional schedule that could be tacked onto the “Schedule of Employer Contributions” – a 10-year “Schedule of Pension Fund Interest and Earnings” showing these two types of variances.

## **2. Diversion of Pension Funds to Pay Retiree Healthcare**

From 1993 through June 2011 MCERA paid about \$40 million in retiree healthcare benefits. County and Retirement officials until very recently said these benefits were paid out of “Pension Fund Excess Earnings”. The truth is they were paid by increasing long-term County debt. If “lost investment return” is included about \$58 million of my County's debt was created by these payments. But there was nothing in the County's financial statements over the past two decades that would have alerted concerned citizens this was happening.

### **a) 1937 County Employees Retirement Act (“1937 Act”)**

This appears in the California Government Code as part of the 1937 Act:

*Article 5 - Financial Provisions - §31592.2. Excess interest; disposition*

*In any county, earnings of the retirement fund during any year in excess of the total interest credited to contributions and reserves during such year shall remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investments, and other contingencies, except that, when such surplus exceeds 1 percent of the total assets of the retirement system, the board may transfer all, or any part, of such surplus in excess of 1 percent of the said total assets into county advance reserves for the sole purpose of payment of the cost of the benefits described in this chapter.*

*Where the board of supervisors has provided for the payment of all, or a portion, of the premium, dues, or other charges for health benefits, Medicare, or the payment of accrued sick leave at retirement to or for all, or a portion, of officers, employees, and retired employees and their dependents, from the county general fund or other sources, the board of retirement may authorize the payment of all, or a portion, of payments of the benefits described in this paragraph from the county advance reserves.*

This is an absurd law. Mendocino County's Pension Fund's target rate of return (and the interest rate) has been 8% for decades. For the County's pension funding "plan" to work the Pension Fund on average must be fully funded AND earn an average net ROI of 8%.

Then – how can it average 8% net ROI if every time earnings in any one year go over 8% they are stripped out of the Pension Fund to pay retiree health benefits?

The answer is obvious – it can't. But that's the law as established by the California Legislature in its infinite wisdom and signed into law by some Governor who must not have understood how averages work.

### **b) What "Excess Earnings"?**

The Pension Fund Actuarial Valuation for 2010 showed its 14 year compound average return on market value was 5.2% - significantly below its target of 8%. The County was forced to borrow \$110 million by selling Pension Obligation Bonds in 1996 and 2002 to eliminate Unfunded Pensions. Unfunded Pension Obligations increased in 14 of the last 16 years (not considering the Bond proceeds). And the Pension Fund has always been under-funded on a market value of investments basis.

If you divert money out of an underfunded Pension Fund to pay anything other than pensions – such as retiree healthcare – then you are driving the Fund deeper and deeper into the hole.

Now – the 1937 Act is law – and the County didn't violate that law to the extent it followed the calculation defined in that law. But I believe the Retirement Association paid out nearly \$10 million of retiree health benefits that can't be justified by the calculation indicated in the 1937 Act. There is nothing in either the County or Retirement Association financial statements that allows readers to see if it did – or not.

Further – the issue isn't only the 1937 Act. There are very significant issues regarding compliance with IRS requirements regarding the tax-deferred status of the Pension Fund. I believe the Retirement Association may well have violated these requirements – but again there is nothing in either set of statements that allows readers to evaluate that threat.

### **c) County Reporting**

This is Note 13 – Post-Retirement Benefits that appears on page 54 of Mendocino County's June 30, 2007 audited statements (the year before GASB 45 was implemented by the County):

*The County pays in accordance with County ordinance, post-retirement medical benefits for retirees who have at least ten years of County service. If the retiree has less than ten years of service, then the retiree pays a percentage of the medical benefits. The benefits paid by the County are funded on a pay-as-you-go basis. At fiscal year-end, there were 907 County retirees, of which, 661 received healthcare benefits totaling \$3,807,490 for the year ended June 30, 2007.*

The County was reimbursed by the Retirement Association for most if not all of its retiree healthcare expenditures since at least 1998 – as far back as my data goes. I carefully reviewed the County's statements for the past four years for this paper and I can find no mention of these reimbursements.

### **d) Retirement Association Reporting**

If I understand GASB 26: "Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans" correctly it requires independent Retirement Systems that provide or administer retiree health benefits to produce the same kind of financial statements related to those funds as they are required to produce for their Pension Funds.

From 1998 through 2002 the two main reports in MCERA's audited financial reports - Changes in Plan Net Assets and Statement of Plan Net Assets – had three columns: "Retirement Plan", "Health Care Plan", and "Totals (Memorandum Only)". Then beginning in 2003 these two funds were no longer reported separately; only one column was reported. It was no longer possible to see information about the financial condition of the two retirement benefits. However "Retirement Benefits" and "Health Care Benefits" were separate line

items under “Deductions”. Then beginning in 2008 MCERA’s audited statements combined those two line items into one – “Benefit Payments and Subsidies”.

I have several times asked for an explanation of why these two benefits are not reported as separate funds but I’ve never gotten what I believe is a “good explanation”. The most I’ve heard is that since the County administers the retiree healthcare plan then MCERA is not obligated to follow the requirement of GASB 26 in terms of reporting healthcare separately from pensions even though the County was reimbursed for its payments of retiree health benefits by MCERA out of so called “Pension Fund Excess Earnings”.

I contacted the California State Controller’s Office – Local Government Reporting Section – and asked the manager and the individual in charge of producing SCO’s Annual Public Retirement Systems Report – an annual compilation of financial and other data. The response I received by email stated:

*In 2001 and 2002 the healthcare fund was reported separately in MCERA’s audited financial statements...  
But starting in 2003 they were combined with the pension benefits into one column.*

*..., since 2003 we have been asking to have the two plans shown separately as they did in prior years and not commingled. As of 2007, the two plans are still commingled.*

However, the Local Government Section manager didn’t want to “get involved” with this “dispute” between a citizen and the County and its Retirement Association and declined to write a letter to the Board of Supervisors describing their view on this issue.

A footnote in the Retirement Association’s financial statements for the fiscal year ended June 30, 2007 states:

*Health insurance benefits for retired employees have been funded by the plan in the past. As of September 1, 1998 the County of Mendocino has assumed responsibility for funding the cost of health care for the retired employees of the County of Mendocino, and will be responsible for the cost of health care when the Association health care reserves have been totally depleted and earnings on investments are not in excess of required transfers of earnings to retirement reserve accounts. For eligibility for health care coverage prior to September 1, 1998, retirees must have served the last 10 years prior to retirement with the County of Mendocino. The retiree health benefit program qualifies under section 401(h) of the Internal Revenue Code.*

The statements don’t present schedules of how the existence of “Pension Fund Excess Earnings” was determined and used, and the paragraph above is the extent to which the audited statements explain the practice of MCERA reimbursing the County for its retiree health benefit payments out of Excess Earnings.

#### **e) GASB’s Proposed Standards Are Significantly Deficient**

The California 1937 County Employee Retirement Act authorizes County Retirement Associations to use “Pension Fund Excess Earnings” as defined above to pay for retiree healthcare. State law allows this practice and I’d think GASB’s standards should structure the reporting of such transfers if they occur.

I see no mention in GASB’s proposed standards regarding the transfer of so called “Excess Earnings” (referred to as “Surplus Earnings” for some City Funds in California) out of the Pension Fund to pay for benefits other than pensions. Given my experience this is a major oversight.

Because of the complexity of the entirety of GASB’s standards I hesitate to offer specific language. But the effect must be to require adequate disclosure and explanation if payments (or reimbursements, or transfers) are made out of the Pension Fund for benefits other than pensions. These should be reported separate from pension benefits – and if such payments for other benefits are “material” the nature of the benefit should be identified – such as retiree healthcare. Further, when “Pension Fund Excess or Surplus Earnings” or any similar concept is used to fund benefits in any way other than pensions the calculations that show how such Excess/Surplus earnings were determined and how they were used should be included in the footnotes.

Both the sponsoring governments and the Pension Fund should include this information in their statements.

This is a huge gap in GASB’s proposed standards.

### **3. Less Significant Causes of Mendocino County's Pension Debt**

#### **a) Unfunded Retroactive Increase of Pension Benefits.**

Mendocino County increased pension benefits retroactively for many employees without providing any funding for the increased pension liability that resulted. GASB's proposed standards will "flush this out" by requiring the expense of such an action to be immediately reported.

#### **b) Disability Retirement Rates Significantly Higher than Actuarial Assumption**

If I understand GASB's proposal correctly I think this would be classified as a "Difference between Expected and Actual Experience". That means the increase in pension expenses created thereby would be reported over the remaining average service life of the present staff. This specific cause –the Retirement Association is approving applications for additional pension payments at a significantly higher rate than is used in the Actuarial assumptions - would not be reported under the proposed standards.

I think that if a specific item within the general category of "Difference between Expected and Actual Experience" is producing a "material" portion of net pension liability, it should be specifically identified both in footnotes and as a note attached to the relevant 10 year schedules and other schedules so that attention can be directed to the "problem" that needs to be solved.

#### **c) Greater than Assumed Growth of Total Salaries**

The comment immediately above covers this cause of my County's net pension liability.

#### **d) Deficient Contributions**

I believe GASB's proposed standards would adequately identify this cause of net pension liability.

### **B. OTHER ISSUES ABOUT EMPLOYER REPORTING**

#### **1. Employer Contributions**

I have two issues with the way employer contributions are reported both today and in the proposed rules.

#### **a) Normal Yearly v. UAAL Amortization Payments**

There is a profound difference between these two, but unless I missed it I think there's only one explanation of the difference in GASB's proposed standards – in the illustrative notes for "Contributions" on page 117:

*The County's rate is determined as the estimated amount necessary to finance benefits earned by members during the year, with an additional amount to finance any unfunded accrued liability.*

I see no requirement to report the value of these two types of payments – there needs to be.

When I first began analyzing my County's financial statements I calculated the proportion that reported salaries and benefits were of total salaries and benefits over a decade. I found that the proportion of benefits grew significantly – it appeared the cost of benefits for County staff was growing significantly faster than salaries.

And so I reported to the readers of my newsletter that the cost of benefits for current staff was steadily increasing. That was a reasonable conclusion based on analyzing the numbers reported in the financial statements. But it wasn't correct.

The County sold a net of about \$75 million new Pension Obligation Bonds in 2002 to eliminate the UAAL that existed at that time, and therefore began to make payments toward the Bonds. I learned around 2007 that the County was reporting the past pension expenses that created the unfunded pension debt essentially on the same schedule as the County was paying off the principal of the POB.

When I pulled the principal payments on the Bonds out of benefits I found the proportion between salaries and benefits did not change over those 10 years. It only seems that benefits had significantly grown relative to salaries because of the amortization of past pension expenses roughly on the same schedule as principal payments on the bonds.



I realize in the future past pension expenses for the most part will not be carried forward for recognition anywhere near the 30 years currently being done by many governments. However this analytical error I made illustrates the need to distinguish between payments to pay down unfunded pensions v. current yearly costs.

It's important to determine how much employer contributions are increasing for current staff v. as a result of amortizing unfunded pensions created in the past..

I suggest that GASB require the two types of employer contributions be reported pretty much wherever the proposed standards for employer reporting require employer contributions to be reported. For example, in the table that presents "Changes in the Net Pension Liability" on page 119 "Contributions-employers" would have two lines – "Normal Yearly Contributions" and "Unfunded Pension Amortization Payments" (or words to that effect).

Further, in notes such as illustrated on page 117 where it says:

*The County's contribution rate for that period was 25.16 percent of annual pensionable payroll.*

I suggest amplifying that sentence to read (as an example):

*The County's contribution rate for that period was 25.16 percent of annual pensionable payroll of which 15.10% was for the County's normal yearly contribution on behalf of its current employees and 10.06% to eliminate the unfunded accrued pension liability for service provided in the past by employees.*

#### **b) Amounts paid by employer on behalf of employees**

At a recent Mendocino County Board of Supervisors meeting a human resources official mentioned as an aside that the County paid a significant amount of the pension contribution for safety employees. At least three Supervisors reacted as if they had no idea that was happening.

The payment of employee contributions by employer governments is a matter of great concern to many people. Whether or not this practice should be modified or banned outright is not an issue for financial reporting, but reporting numbers of interest to officials and the public is.

Clearly most people see a table like "Changes in the Net Pension Liability" on page 119 and interpret the part of the table that reports:

Contributions – employer	109,544
Contributions – member	51,119

... as meaning the "members"- i.e. employees paid that amount by having it withheld out of their salaries. But that's often not what's happening. Many governments pay part of the employee contribution.

This table should show (as an example):

Contributions – employer	109,544
Contributions – member	
Paid by employer on behalf of employees	20,000
Paid directly by employees	31,119

I suggest this distinction be made wherever member – or employee contributions is reported.

Further, this distinction should be made in footnotes such as the illustrative note on "Contributions" on page 117. Instead of:

*The average member rate for the period ended December 31, 20X9, was 11.74 percent of annual pay.*



... the entire note should read something like this if the employer pays part of employee contributions:

*The average member rate for the period ended December 31, 20X9, was 11.74 percent of annual pay. However the County agreed to pay half the contribution for current safety employees. This reduced the total paid by members to 8.74 percent. The County's contribution rate for that period was 25.16 percent of annual pensionable payroll of which 15.10 percent was for the County's normal yearly contribution on behalf of its current employees and 10.06 percent to eliminate the unfunded accrued pension liability. In addition the County's payments of half the safety employee's contribution increased the County's total contribution to 28.16 percent and its contribution on behalf of current employees to 18.10 percent. (Underlines added.)*

My experience tells me most concerned citizens don't know about agreements under which the government pays part of the employee's contribution but would want to know if such agreements exist.

## 2. Add UAAL Payments to Schedule of Long-Term Liabilities

The net pension liability is a liability and payments to eliminate it are payments of a debt. They need to be incorporated into the footnotes regarding Long-Term Liabilities. This shows this schedule "Summary of Long-Term Liabilities" in Mendocino County's 6/30/09 statements with the addition I suggest:

	Balance July 1, 2008	Additions	Deletions	Balance June 30, 2009	Amounts Due Within One Year
Certificates of participation	\$26,240,000	\$-	\$(660,000)	25,580,000	730,000
Bonds payable	92,160,000	--	(2,885,000)	89,275,000	3,055,000
Loans payable	2,776,102	--	(231,551)	2,544,551	513,523
Capital leases	933,532	--	(387,260)	546,272	282,651
Compensated absences	4,747,691	4,688,366	(4,036,121)	5,399,936	5,399,936
Liability for self-insurance	3,861,207	11,587,283	(11,399,100)	4,049,390	4,049,390
Landfill postclosure costs	7,654,198	748,886	--	8,403,084	--
<b>Net Pension Liability</b>	<b>40,587,979</b>	<b>91,419,536</b>		<b>132,007,515</b>	<b>3,695,597</b>

Yes – 2009 was a really bad year, but this is what happened and the public should see it.

This is the payment schedule shown in that footnote with the addition of net pension liability:

Year Ending June 30:	Certificates of Participation		Bonds Payable		Loans Payable		Net Pension Liability	
	Principal	Interest	Principal	Interest	Principal	Interest	Principal	Interest
2010	\$730,000	\$1,292,102	\$3,055,000	\$4,848,443	\$513,523	\$103,430	(1,659,083)	5,354,680
2011	720,000	1,260,234	3,240,000	4,675,324	535,766	81,186	(1,439,093)	7,057,404
2012	755,000	1,228,702	3,405,000	4,509,199	558,961	57,993	(2,593,153)	11,694,893
2013	790,000	1,192,328	3,575,000	4,334,699	583,183	33,769	(3,200,663)	14,986,427
2014	830,000	1,153,718	3,755,000	4,151,449	313,647	8,509	(3,335,564)	16,512,406
2015-2019	4,780,000	5,134,610	21,995,000	17,383,108	39,471	1,571	(11,871,188)	86,096,014
2020-2024	6,895,000	3,809,122	28,780,000	10,407,914	--	--	1,312,101	88,993,749
2025-2029	8,175,000	1,830,898	21,470,000	1,904,389	--	--	24,745,954	85,124,921
2030-2034	1,905,000	100,012	--	--	--	--	64,121,567	69,553,161
2035-2039							127,991,902	34,643,833
	\$ 25,580,000	\$17,001,726	\$ 89,275,000	\$52,214,525	\$ 2,544,551	\$286,458	194,072,780	420,017,478

Sobering – isn't it?

No one in either the Retirement Association or the County of Mendocino has developed an amortization schedule for the entire unfunded pension obligation. Because the Pension Fund uses a 5 year smoothing period and the first UAAL amortization payments were to occur in the next year they only produced an amortization schedule for the amount of UAAL that would be recognized at the beginning of the year - \$67 million. The rest of the real market-value unfunded obligation would “drop out of smoothing” over the following 4 years but no projections were made for those amortization schedules

I projected payments for the Net Pension Liability based on the assumption that everything in the Pension Fund would occur as planned in the future – it will earn its target rate (8%) on the assets it has, the growth of salary will be exactly as projected, people will obligingly pass away on schedule, etc. I believe this assumption should be part of GASB’s requirements for projecting future Net Pension Liability amortization payments.

You may notice that the total payment on principal for the Net Pension Liability on this schedule is \$194 million in contrast to the amount reported as the balance due in the previous table of \$132 million. There are several reasons for this.

The biggest reason (there are two others I won’t describe) principal payments will be so much more than the beginning principal is the County chose to amortize the unfunded pensions using the level percent of payroll method that creates “negative amortization” for the first 12 years. The debt will grow very significantly.

When I pointed out their amortization schedule had “negative amortization” and was incorrectly calculated to boot Retirement and County officials denied it. However, a year later their Actuary confirmed both were true. The Retirement Administrator, Retirement Board, County Board of Supervisors, the Auditor-Controller and Treasurer-Tax Collector didn’t accept there was negative amortization until it was confirmed by the Actuary!

That alone is more than enough justification to require governments to report projected total future amortization payments including those for amounts of unfunded pensions that have not yet been incorporated into those amortization payments because of smoothing.

Even if the Pension Fund meets all its assumptions in the future (which it hasn’t in the past) my County will pay a total of about \$600 million to eliminate the Net Pension Liability. That should be reported to the people.

(Note – I produced these projected amortization payments a year ago under a number of future scenarios. I haven’t checked the math for this paper but the tables above work as an illustration of what I’m talking about.)

### **3. Cost Sharing Plans**

My County has its own Pension Fund – it doesn’t participate in CalPERS. A couple of very small special districts and the County’s Superior Court employees participate in the Fund but they are a relatively insignificant portion of the total participants. The County describes the plan in these terms in Note 11 on page 51 of its 6/30/11 statements:

*The Mendocino County Employee’s Retirement Association is a multiple employer defined benefit pension plan serving the employees of the County of Mendocino and two special districts.*

(This note doesn’t say the County uses the “Cost-Sharing” method of accounting as defined by GASB. Shouldn’t it?)

In contrast this is part of the corresponding footnote in the County of Sonoma’s 6/1/11 statements on page 68:

*The Retirement Association administers a cost sharing, multiple-employer Defined Benefit Pension Plan (Plan), and a Postemployment Healthcare Plan (PH Plan), and is financially independent of the County. For purposes of accounting and financial reporting, the plan is treated as a single employer plan as the majority of the participants are employees of the County.*

Sonoma County also has its own separate Pension Fund organized under the 1937 Act. And it also has a few very small other government employers in the Pension Fund. But Sonoma County reports the finances of its Pension Fund as if the Plan were “Single Employer” rather than a “Cost-Sharing” plan.

I don't know if Sonoma County is conforming to GASB standards in this matter or not. However, I believe that if the primary government in a Cost-Sharing plan represents the overwhelming majority of the finances of the plan, then it should do as Sonoma does and report as if it were a "Single Employer" in terms of GASB's proposed standards. I'm not sure what the threshold percentage would be – 95%?

If what Sonoma does is acceptable, then shouldn't there be firm language in the standards that defines the conditions under which the main sponsoring government must (and I think it should be must) report the finances of the Pension Fund as a Single Employer Fund?

In addition, I have wondered for some time about the "balance" and "fairness" between Mendocino County and the other small government employers in the plan. Are the other small governments contributing their "share" of employer normal contributions? Are they paying their share of UAAL amortization payments? There were a few years in which Mendocino County didn't contribute the full amount specified by the Actuary. Did the small governments pay their share – and if so, isn't that "unfair" since in a Cost-Sharing Plan they share in the burden to eliminate the resulting UAAL?

I think citizens should be able to see if the other governments in a Cost-Sharing Plan are "doing their part" and that all participating governments are being treated "fairly".

#### **4. Pension Obligation Bonds**

I realize this may not be considered part of pension reporting in the context of GASB's proposed standards, but I believe my County's reporting regarding its the Pension Obligation Bonds did not convey to citizens the real "meaning" of what happened.

The County sold its second round of Pension Obligation Bonds in fiscal year ending June 30, 2003. (Its first round was sold in 1996.) This is part of a footnote describing long-term liabilities in the audited statements for fiscal year 2002-2003 (page 47):

##### *Long-Term Liabilities (continued) - A. Summary of Long-Term Liabilities (continued) - New Debt*

*On December 19, 2002, the County issued \$91,945,000 of Taxable Pension Obligation Bonds, Refunding Series 2002 (the "2002 Bonds"). The proceeds of the 2002 Bonds were issued (i) to refund the obligation of the County to the County of Mendocino Employees' Retirement Association evidenced by the 2002 debenture, (ii) to defease a portion of the County of Mendocino Taxable Pension Obligation Bonds, Series 1996, and (iii) to pay the costs of issuance of the 2002 Bonds. The County's obligation with respect to the 2002 Bonds is an absolute and unconditional obligation imposed upon the County by law and enforceable against the County pursuant to the retirement law and payment of principal and interest on the 2002 Bonds is not limited to any special source of funds of the County. The Bonds will mature annually on July 1 of each year starting in 2004 and ending in 2026. Interest on the Bonds is payable semi-annually on January 1 and July 1 of each year, commencing July 1, 2003. Interest rates range from 2.07% to 5.77%.*

I know with certainty that few citizens who read this explanation understood what happened and why. What was "the 2002 debenture"? What does "defease" mean?

The footnote didn't explain that the County borrowed this money because its Pension Fund had a significant unfunded obligation the County had to eliminate and it chose to borrow money to do that because unfunded pension debt incurs an effective 8% interest rate whereas the POB incurs only a 4% rate. I think governments should have to make this explanation when they sell Pension Bonds.

## 5. Picky Details

### a) Interest on Beginning Net Pension Liability or Average Net Liability?

Paragraph 28 sub a(2) states:

*Interest on the total pension liability should be included in current-period pension expense. Interest should be calculated using the discount rate used in calculating the beginning total pension liability (as identified in paragraph 25).*

Should that be interest on the beginning balance of Net Pension Liability of Average Balance through the year? If on average balance would it be a simple average of the beginning and ending values?

### b) Remaining Service Lives

Paragraph 28 sub a(2) establishes that the part of the effects of several categories of pension-expense creating items ascribed to current staff will be amortized over the expected remaining service life of that staff. In the illustrative footnote on page 117 the section that lays out various Actuarial assumptions shows the Amortization Period to be 15 years. Shouldn't that be explained – that it is the estimated remaining service life of the current staff and is used to spread certain pension expenses over the remaining average service life?

### c) Discount Rate Sensitivity

The illustrative footnote regarding the sensitivity of Net Pension Liability related to the discount rate on page 118 states:

*Sensitivity of the Net Pension Liability to the Discount Rate Assumption. The following presents the current-period net pension liability of the County calculated using the current-period discount rate assumption of 7.75 percent, as well as what the net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (6.75 percent) or 1-percentage-point higher (8.75 percent) than the current assumption:*

As I say my concern is with the ability of “normal concerned citizens” to understand the financial statements of their local governments. I think most citizens wouldn't know what issue is being addressed.

I think this note should tell citizens that the importance of this information is to show what would happen if the Pension Fund earns more or less than its target rate of return. The value reported for today's Net Pension Liability is an estimate based on the assumed Pension Fund rate of return. If it turns out the Pension Fund earns more than the assumed rate of return and we used the higher rate to estimate the value of today's Net Pension Liability, then today's Net Pension Liability would have been lower. Likewise if the earnings turn out lower than expected and we used that lower rate the debt would have been reported to be higher. It's a measurement of the risk related to the Pension Fund's rate of investment returns.

## VI. PENSION FUND FINANCIAL REPORTING

As described in “**Diversion of Pension Funds to Pay Retiree Healthcare**” on page 8 Mendocino County's Retirement Association diverted so-called “Excess Earnings” out of the Pension Fund to reimburse the County for the County's retiree healthcare benefit.

I suspect this practice may have violated certain IRS regulations regarding qualification for tax-deferral status of the pension plan, and I'm convinced the Association did not follow the requirements of the 1937 County Employees Retirement Act in how they calculated Pension Fund Excess Earnings.

This brings up an interesting quandary – should GASB's standards require entities to report activities that should never have to be reported because they aren't supposed to happen?

Of course they should.

As I said in that earlier section,

*Because of the complexity of the entirety of GASB's standards I hesitate to offer specific language. But the effect must be to require adequate disclosure and explanation if payments (or reimbursements, or transfers) are made out of the Pension Fund for benefits other than pensions. These should be reported separate from pension benefits – and if such payments for other benefits are “material” the nature of the benefit should be identified – such as retiree healthcare. Further, when “Pension Fund Excess or Surplus Earnings” or any similar concept is used to fund benefits in any way other than pensions the calculations that show how such Excess/Surplus earnings were determined and how they were used should be included in the footnotes.*

*Both the sponsoring governments and the Pension Fund should include this information in their statements.*

Citizens need to see if their government's Pension Fund is using such a practice and what the impact is on the financial health of the Pension Fund.

Another wrinkle – the County's Pension Fund reported its return on investment BEFORE so-called Excess Earnings were transferred out of the Pension Fund. So when the Actuary reported in the Actuarial Valuation for 2010 that the Fund's 14 year compound average return on market value was 5.2%, that percentage was calculated for returns before so-called Excess Earnings were taken out of the Fund.

The Pension Fund earned about \$140 million net investment income during those years. About \$35 million (25% of the net income) was diverted to pay retiree healthcare by use of the “Excess Earnings” method. Therefore the amount of net investment income that was retained in the Pension Fund was only 3.9%.

I submit the proper percentage return to report is 3.9% - not 5.2% because those earnings were not generated in order to provide pensions. They were generated in order to pay retiree healthcare. That's important for citizens to know.

## END NOTES

---

<sup>i</sup> SCO does not include unfunded retiree obligations as debt in its *Annual Counties* report. Such unfunded benefits are not listed in audited financial reports as debt (this analyst believes they should). However, they are disclosed in “Required Supplementary Information” in the financial statements. However, SCO doesn't include this Supplementary Information in its Annual Counties report (this analyst believes they should). Therefore they are not included in the tables above.

Debt related to most real estate purchases is also not included. Most California counties use a financing technique known as “Certificates of Participation” (“COPS”) to finance real estate purchases. The county itself doesn't buy the property. It sets up a non-profit corporation (often titled a “Facilities Corporation”) that it controls, and that non-profit buys the property. The Corporation finances the purchase by the sale of COPS to investors. It then leases the property to the county for enough to pay the principal and interest on the COPS. The amount reported in the SCO Annual Counties Report combines principal and interest, and is therefore expressed differently from other debt which only lists principal. Therefore COPS are excluded from this analysis.

The debt that is reported in the SCO report includes all Bonds, Loans, Notes, and many other forms of long term debt. It allows a good (but not complete) comparison of counties' debt.