

TWO PAGE ABSTRACT

Predictor Model - GASB Statement 68

New Government Financial Reporting Rules for Pension Finances

California Counties with “Independent” Pension Funds

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Introduction

Many California local governments suffer from excessing unfunded retiree debt – some more, some less. But today’s government financial statements hugely understate the cost of government pensions and the debt they create. New government accounting rules (“GASB 68”) were passed June 25, 2012 that will radically improve these reports. But the new reports mostly won’t be available until 2016 – much too late to help citizens and officials make good decisions now. We developed a Predictor Model to show the impact of these new rules.

General

The model was designed for the 21 California counties with independent Pension Funds. The main values projected are Net Pension Liability, Annual Pension Expense, and Prior Year Pension Expenses to be reported during transition. We model the impact on Government wide financial statements using full accrual – the Statement of Net Assets and Statement of Activities (or Statement of Changes in Net Assets). The model restates several years of recent audited financial statements to show what they would have been under the new rules. We don’t restate Fund Accounting reports. Data must come from at least 10 years of audited financial statements and actuarial valuations. We combine the results of the new rules with remaining balances of Pension Obligation Bonds and their interest expense to show the total financial impact of unfunded pensions.

Main Provisions of GASB 68 to be Modeled

GASB 68 requires the Entry Age Actuarial Method to be used to calculate Total Pension Liability. GASB does not “smooth” investment returns in calculating Net Pension Liability but it does smooth in calculating Pension Expense. The main rules are expressed for Single and Agent Employer Pension Funds – the results are allocated to individual governments that participate in Cost-Sharing Funds.

Net Pension Liability: A Net Pension Liability (or Asset) will be reported in the Statement of Net Assets: Total Pension Liability less “Plan Fiduciary net Position” (essentially Pension Assets at market value). GASB 68 defines a complex cash flow analysis to project if and when a Pension Fund will run out of money. If so a high-grade municipal bond index rate will be “blended” into the Fund’s target rate of return to produce a “blended” discount rate. We don’t attempt to model this complex calculation. We will use the Actuarially Accrued Total Liability.

A “Ten-Year Schedule of Changes in Net Pension Liability” must be included in footnotes. It shows first - Changes in Total Pension Liability caused by Service Cost, Interest (average total liability x target rate of return), Benefit Changes, Differences between Expected and Actual Actuarial Experience, Changes in Actuarial Assumptions, and Pension Payments. Second is Changes in Plan Fiduciary Net Position (Assets) caused by Employer and Employee Contributions, Net Investment Income, Benefit Payments (including non-pension benefits from the Pension Fund), Pension Fund Administrative Expenses, and Other Changes. The total impact is Change in Net Pension Liability.

This new definition of Net Pension Liability or Asset completely replaces previous rules. Net Pension Assets reported today associated with past Pension Bond will be completely written off the books – often a huge impact.

Pension Expense: All values in the Schedule of Changes in Net Pension Liability are included in Pension Expense in the year they occur with 4 modifications. First, employer contributions are not included (in accrual accounting payment of an expense doesn’t affect the value of the expense). Second, a set of rules for “Special Funding Situations” is defined. We don’t believe these exist for our “target” 21 counties and will not attempt to model these rules.

The last 2 modifications require that annual changes in three variables be included (amortized) in reported annual pension expense gradually over a number of years in the future. The “Difference between Projected and Actual Return on Investment” must be amortized over 5 years. Both “Differences between Expected and Actual Actuarial Experience” and the impact of “Changed Actuarial Assumptions” must be included in Pension Expense over the average remaining years of employment of current staff, vested terminated employees not yet drawing pensions, and retirees.

For Cost Sharing Employers values calculated for the entire Pension Fund for Net Pension Liability and Pension Expense are allocated to individual employers mostly based on proportional share of employer contributions. We will not attempt to model several other complex but less impactful allocation elements.

In the year GASB 68 is implemented the value of previously reported Net Pension Assets related to Pension Obligation Bonds will be written off and the value of new Net Pension Liability (or Asset) will be included. The sum of these two (Net Asset written off and Net Liability reported) will reduce “Unrestricted Net Assets”. That will be reported as a “prior year adjustment” as previously unreported pension expenses.

Construction & Explanation of Model

We will not include the value of “Benefit Changes” because the data is not easily available. We will combine “Differences in Expenses & Actual Actuarial Experience” and “Assumption Changes” since they are treated the same in Pension Expense. In effect the value of Benefit Changes will be included in this combined variable.

Independent variables are data obtained from audited statements or actuarial valuations. These include Target Rate of Return, Annual Service Cost (Normal Cost), Actuarially Accrued Liability, Contribution Rates and Projected Values for Cost Sharing Plans, Benefit Payments, Net Investment Income, Expected Income, Employer and Employee Contributions, Pension Fund Administrative Expenses, and the Value of Pension Fund Assets.

Dependent variables are produced by formulas in the model. “Interest” is essentially the average Total Pension Liability x Target Rate of Return – somewhat modified to conform to GASB illustrations. The combined variable “Difference in Expected & Actual Actuarial Experience & Assumption Changes” is the result of the values of all other independent variables in the Change in Total Pension Liability. “Other Changes in Plan Fiduciary Net Position” results from the values of all independent variables in the Change in Plan Fiduciary Net Position.

For the calculation of annual Pension Expense we amortize the “Difference between Expected & Actual Investment Return” straight-line over 5 years. We amortize the combined variable “Difference between Expected and Actual Actuarial Experience & Assumption Changes” straight-line over 8.25 years – a value we calculated from GASB illustrations. (However – we are considering whether we can make a more precise measurement for each employer based on readily available data).

We will allocate these values for Cost Sharing Employers using a hierarchy of preferred methods. First – proportional dollar contributions. If not available – proportion of active employees. However, we will include the values for the Pension Fund as a whole in counties that produce more than 90% of the Pension Fund’s finances.

Output

We will show the 10-Year Schedule of Changes in Net Pension Liability, the Calculation of Pension Expense for as many years as possible, the impact of GASB 68 on summary financial statements, and the combined impact with Pension Bonds to show the total financial impact of unfunded pensions. We’ll show sample analysis based on the new reports.

Demonstration Application of Model – Mendocino County

Nearly 2 decades of financial information for Mendocino County was entered into the model. Results are draft at this time. Total Revenues are around \$200 million. The County’s “Net Worth” as of June 30, 2011 was reported as \$75 million. It would have declined \$175 million to a negative (\$100 million). “Unrestricted Net Assets” (“Retained Earnings” in private sector for-profit accounting) was reported as a negative (\$25 million) in June 2011. GASB 68 would have reduced it to a negative (\$200 million). Pension Expenses would have increased about \$25 million a year. Yearly margin would have declined from a range of positive \$8 million to \$13 million down to negative (\$10 million) to (\$15 million).