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GASB Statement 68 Predictor Model
Government Financial Reporting of Pension Finances

Application to the County of Mendocino
8/8/12

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I've produced a Predictor Model to project what the impact of new government pension finance reporting standards defined in Governmental Accounting Standards Board Statement 68 (GASB 68) would have been on recent financial statements of the 21 California counties that have their own independent Pension Funds rather than participate in CalPERS. That Model is described in a separate document titled:

Construction of Predictor Model
GASB Statement 68
Government Financial Reporting of Pension Finances
California Counties with "Independent" Pension Funds
8/8/12

The purpose of this specific paper is to provide an example of the results of that draft Predictor Model using "real world" financial data for such a county – Mendocino County.

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I. "First Cut – Draft" Application of Model – Mendocino County

We have a "rich financial data set" for Mendocino County extending back to the mid-to-early 1990's that includes financial reports for both the County and its independent Pension Fund. We applied our draft GASB 68 Predictor Model to the County and these show the draft review results. This is the first application of the model to an actual government.

We estimated the impact GASB 68 would have had on the County's financial statements for 2011, 2010, and 2009.

This is complex modeling. It hasn't yet been "tested" by a Peer Review; it needs to be. Therefore these results are produced by an "un-reviewed" complex model and could change after a complete competent review. However, the scale of the results compared to what was reported is very significant and I doubt the fundamental conclusions would change.

The purposes of this presentation of this "trial run" are a) to test the model, b) to show the type of information the model will produce for the 21 counties, c) to begin to understand and explain the greatly increased value of the new information to be produced by GASB 68, and d) to once again try to get across to Mendocino County officials and the public how little they understand what's really happening to the finances of the County for which they are responsible – trying to convince them the longer they take to confront the underlying drivers of this slowly unfolding disaster the worse it's going to get.

Mendocino County is the smallest of the 21 counties that don't participate in CalPERS in terms of population (90,000), total County revenues (about $200 million), and Pension Fund (about $500 million in Total Pension Liability and $350 million in the market value of Pension Assets).

II. Summary of Impacts

These are the changes GASB 68 would have imposed on Mendocino County's June 30, 2011 financial statements.

	Reported in County Statements	Would Have Been Under New Rules
Pension Expense	$15 Million	**$41 Million**
Yearly "Bottom Line" (Before "Special One-Time Adjustments")	$13 Million	**Negative ($13 Million)**
Total Assets	$220 Million	**$163 Million**
Total Debt	$145 Million	**$263 Million**
County's Net Worth	$75 Million	**Negative ($100 Million)**
Unreported Past Pension Expenses Disclosed in One Year		**$175 Million**

These are some of the impacts over the 3 years were have enough data to project.

PENSION EXPENSES	2009	2010	2011
Historical Financial Statements	9.1 million	13.8 million	15.0 million
Adjusted to GASB 68	35.9 million	38.3 million	40.6 million
Increase in Dollars	26.8 million	24.5 million	25.6 million
Percent Increase	294%	178%	177%

BOTTOM LINE BEFORE SPECIAL ONE-TIME ITEMS	2009	2010	2011
Historical Financial Statements	8,6 million	11.5 million	12.8 million
Adjusted to GASB 68	(18.2 million)	(16.5 million)	(16,1 million)

III. Write Off of Current Net Pension Asset

The current definition of Net Pension Assets or Liabilities will be entirely replaced by the provisions of GASB 68. The County of Mendocino reported values of $67.5 million, $62.3 million, and $56.9 million in 2009, 2010, and 2011. Those will be entirely removed from the County's Balance Sheet (Statement of Net Assets). They were more than half of reported Current Assets and 30% of the County's reported Total Assets.

One-third of the County's reported assets will simply disappear. But they never were real assets anyway. (This is explained in the full description of the model.)

IV. CHANGES IN NET PENSION LIABILITY

GASB 68 will require governments to put 10-year schedules of the changes in Total and Net Pension Liability in the footnotes to the financial statements.

COUNTY OF MENDOCINO

Changes in Net Pension Liability - GASB 68 Format - DRAFT

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
TOTAL PENSION LIABILITY										
Service Cost	10,682,027	12,004,060	10,996,819	10,793,956	11,684,735	13,535,259	13,844,780	15,361,062	14,736,333	15,000,919
Interest	16,141,167	17,586,415	19,017,264	20,742,339	22,798,666	25,371,487	27,380,203	29,060,847	31,348,044	33,945,410
Benefit Changes (info not available - included in Next Item)	0	0	0	0	0	0	0	0	0	0
Expected v. Actual Experience & Assumption Changes	4,761,829	(2,815,914)	2,746,909	4,992,149	10,118,390	14,417,899	(8,837,696)	2,588,961	6,040,393	11,025,035
Pension Payments & Refunds (Doesn't Include Healthcare Payments)	(9,401,023)	(10,315,561)	(10,961,992)	(12,202,444)	(13,945,791)	(15,188,645)	(16,814,287)	(17,646,870)	(20,333,770)	(22,314,081)
NET CHANGE TTL PENSION LIAB	22,184,000	16,459,000	21,799,000	24,326,000	30,656,000	38,136,000	15,573,000	29,364,000	31,791,000	37,657,283
TTL PENSION LIAB - BEG.	204,699,000	226,883,000	243,342,000	265,141,000	289,467,000	320,123,000	358,259,000	373,832,000	403,196,000	434,987,000
TTL PENSION LIAB - END.	226,883,000	243,342,000	265,141,000	289,467,000	320,123,000	358,259,000	373,832,000	403,196,000	434,987,000	472,644,283
Rate of Change	11%	7%	9%	9%	11%	12%	4%	8%	8%	9%
PLAN FIDUCIARY NET POSITION										
Contributions - Employers										
Pension Contributions	6,348,000	6,663,000	2,619,540	1,513,870	3,946,840	7,533,000	7,232,000	8,524,860	8,234,253	9,553,955
Unfunded Pension Amortization Payments										5,093,015
Diversion of Pension Contributions to Pay Healthcare			1,728,689	2,662,304	1,739,719					
POB Proceeds	0	76,299,000	0	0	0	0	0	0	0	0
Contributions - Employees	4,334,027	5,341,060	6,648,590	6,617,782	5,998,176	6,002,259	6,612,780	6,836,202	6,502,080	5,446,964
Net Investment Income	(8,349,757)	10,538,948	34,539,622	24,878,370	30,976,463	50,991,137	(28,174,415)	(53,511,078)	38,128,443	64,075,101
Pension Payments (incl. refunds)	(9,401,023)	(10,315,561)	(10,961,992)	(12,202,444)	(13,945,791)	(15,188,645)	(16,814,287)	(17,646,870)	(20,333,770)	(22,314,081)
Payment of Retiree Healthcare from Pension Funds	(2,295,076)	(2,256,850)	(2,758,826)	(2,680,365)	(3,410,319)	(3,382,351)	(3,950,000)	(4,399,000)	(3,896,000)	(1,709,166)
Admin. Exp.	(197,137)	(251,509)	(360,445)	(252,721)	(347,765)	(415,588)	(426,194)	(601,879)	(644,865)	(639,764)
Other	161,350	175,377	553,218	7,063,566	(861,169)	(2,283,649)	13,173,023	(1,257,771)	863,936	(4,506,063)
NET CHANGE PLAN FIDUCIARY NET	(9,399,616)	86,193,465	32,008,396	27,600,362	24,096,154	43,256,163	(22,347,093)	(62,055,536)	28,854,077	54,999,961
PLAN POSITION - BEG.	151,836,190	142,436,574	228,630,039	260,638,435	288,238,797	312,334,951	355,591,114	333,244,021	271,188,485	300,042,562
PLAN POSITION - END.	142,436,574	228,630,039	260,638,435	288,238,797	312,334,951	355,591,114	333,244,021	271,188,485	300,042,562	355,042,523
Change (Memo)	(9,399,616)	86,193,465	32,008,396	27,600,362	24,096,154	43,256,163	(22,347,093)	(62,055,536)	28,854,077	54,999,961
NET PENSION LIABILITY										
Beginning	(52,862,810)	(84,446,426)	(14,711,961)	(4,502,565)	(1,228,203)	(7,788,049)	(2,667,886)	(40,587,979)	(132,007,515)	(134,944,438)
Ending	(84,446,426)	(14,711,961)	(4,502,565)	(1,228,203)	(7,788,049)	(2,667,886)	(40,587,979)	(132,007,515)	(134,944,438)	(117,601,760)
Change Net Pension Liability	31,583,616	(69,734,465)	(10,209,396)	(3,274,362)	6,559,846	(5,120,163)	37,920,093	91,419,536	2,936,923	(17,342,678)
Plan Position/Total Pension Liab.	62.78%	93.95%	98.30%	99.58%	97.57%	99.26%	89.14%	67.26%	68.98%	75.12%

Two major issues are the values calculated for Expected v. Actual Experience & Assumption Changes in the Changes in Total Pension Liability and "Other" Changes in Changes in Pension Fund Fiduciary Net Position. These values are the amounts necessary to "balance" GASB's formulas to explain the changes in Total Pension Liability and Plan Net Position respectively. Is there this much volatility and probable "inaccuracy" in the Actuarial assumptions and projections produced for MendoCERA? And is there this much "imprecision" in MendoCERA's financial reporting of the components of its Fiduciary Position? Unfortunately MendoCERA has a history of producing very significant errors in both its Actuarial Valuations and Audited Financial Statements, and therefore these "unexplained variances" may well be explained by uncorrected errors in financial and actuarial reports.

Whatever the cause, these are the numbers necessary to reconcile MendoCERA's reported changes. Both MendoCERA and County financial officials should be able to explain what caused these values. They can't.

V. Annual Pension Expenses

GASB 68 does not require presentation of the calculation of pension expense in footnotes to financial statements. We believe a 10-year schedule of the components of Pension Expense should have been required in order to focus attention on where the problems are.

We can't produce a full 10-year schedule because our data series doesn't extend far enough back to encompass the 8.25 year amortization period of Differences in Expected v. Actual Actuarial Experience.

This schedule presents the model's calculation of what the reported value of Mendocino County's pension expense would have been had GASB 68 been in effect for fiscal years 2009 through 2011.

COUNTY OF MENDOCINO
Calculation of Annual Pension Expense - GASB 68 Format - DRAFT

	2009	2010	2011
Recognized in One Year			
Values from Government Reports			
Yearly "Normal" Service Cost	15,361,062	14,736,333	15,000,919
Pension Fund Administrative Expenses	601,879	644,865	639,764
Employee Contributions	(6,836,202)	(6,502,080)	(5,446,964)
From Reports or Calculated if NA			
Expected Return from Valuation	(26,278,512)	(21,494,203)	(23,640,399)
Values Calculated in This Model			
Interest at Target Rate of Return	29,060,847	31,348,044	33,945,410
Other	1,257,771	(863,936)	4,506,063
Subtotal	13,166,845	17,869,023	25,004,793
Recognized over Several Years			
Diff - Expected v Actual Investment Return	19,232,285	16,773,437	10,437,913
Expected v. Actual Experience & Assumption Changes	3,462,590	3,689,885	5,137,947
Pension Expense	35,861,720	38,332,345	40,580,653
Note - Retiree Healthcare from Pension Fund	4,399,000	3,896,000	1,709,166

VI. Total Impact of GASB 68 on Financial Statements

This shows what the changes in the County's financial statements would have been had GASB 68 been in effect in these years, assuming this model is correct.

STATEMENT OF NET ASSETS	Historical Audited Statements			ADJUSTMENTS - GASB 68			Restated Audited Statements		
Assets	2009	2010	2011	2009	2010	2011	2009	2010	2011
Current									
Other	45,844,581	51,657,477	62,520,243		Remove Net Pension Asset		45,844,581	51,657,477	62,520,243
Net Pension Asset	67,449,185	62,348,132	56,944,627	(67,449,185)	(62,348,132)	(56,944,627)			
Total Current	113,293,766	114,005,609	119,464,870				45,844,581	51,657,477	62,520,243
Non-Current	93,074,751	101,041,841	100,307,029				93,074,751	101,041,841	100,307,029
Total Assets	206,368,517	215,047,450	219,771,899				138,919,332	152,699,318	162,827,272
Liabilities									
Current	34,543,085	47,107,653	31,665,646		Add Net Pension Liability		34,543,085	47,107,653	31,665,646
Non-Current	127,993,733	122,964,323	113,148,484	132,007,515	134,944,438	117,601,760	260,001,248	257,908,761	230,750,244
Total Liabilities	162,536,818	170,071,976	144,814,130				294,544,333	305,016,414	262,415,890
Net Assets									
Capital Assets, Net	64,403,928	73,868,603	74,585,302				64,403,928	73,868,603	74,585,302
Restricted	21,589,827	21,402,865	25,669,041		Reduce Unrestricted Net Assets		21,589,827	21,402,865	25,669,041
Unrestricted	(42,162,056)	(50,295,994)	(25,296,574)	(199,456,700)	(197,292,570)	(174,546,387)	(241,618,756)	(247,588,564)	(199,842,961)
Total Net Assets	43,831,699	44,975,474	74,957,769				(155,625,001)	(152,317,096)	(99,588,618)
Liabilities + Net Assets	206,368,517	215,047,450	219,771,899				138,919,332	152,699,318	162,827,272
STATEMENT OF ACTIVITIES									
Programs									
Revenues	130,741,032	133,967,209	137,289,801		Additional Pension Expense		130,741,032	133,967,209	137,289,801
Less: Expenses									
Pension Expense	9,107,000	13,811,000	14,957,000	26,754,720	24,521,345	25,623,653	35,861,720	38,332,345	40,580,653
Other Expense	167,787,628	160,349,687	159,746,913				167,787,628	160,349,687	159,746,913
Total Expenses	176,894,628	174,160,687	174,703,913				203,649,348	198,682,032	200,327,566
Net Programs	(46,153,596)	(40,193,478)	(37,414,112)				(72,908,316)	(64,714,823)	(63,037,765)
General Revenues									
Taxes	57,931,479	54,886,954	54,531,255				57,931,479	54,886,954	54,531,255
Other	4,381,583	3,740,919	2,291,692				4,381,583	3,740,919	2,291,692
Total General Revenue	62,313,062	58,627,873	56,822,947				62,313,062	58,627,873	56,822,947
Yearly Margin Before Interest	16,159,466	18,434,395	19,408,835				(10,595,254)	(6,086,950)	(6,214,818)
Interest on Debt Service	7,593,045	6,965,035	6,579,594				7,593,045	6,965,035	6,579,594
Change in Net Assets Before Special Items	8,566,421	11,469,360	12,829,241				(18,188,299)	(13,051,985)	(12,794,412)
Special - One Year Items		(10,325,585)	17,153,054					(10,325,585)	17,153,054
Change in Net Assets	8,566,421	1,143,775	29,982,295				(18,188,299)	(23,377,570)	4,358,642

VII. Total Impact of Unfunded Pensions Including Pension Bonds

Pension Bonds are simply restructured unfunded pensions, or, in GASB 68 terms, Net Pension Liability. Their cause is the same – unfunded pensions. Outstanding Pension Bond debt must be added to Net Pension Liability to determine the total debt caused by unfunded pensions. And the interest expense of Pension Bonds must be added to the interest impact of the county's pension obligations to understand the annual "capital cost" of the county's pension benefits. We show the values back to 1997 because we have the data.

Table 1 – Impact of Net Pension Liabilities and Pension Obligation Bonds

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
NET PENSION LIABILITIES															
Total Pension Liability															
Beginning	130,036,000	140,783,000	154,263,000	173,250,000	185,423,000	204,699,000	226,883,000	243,342,000	265,141,000	289,467,000	320,123,000	358,259,000	373,832,000	403,196,000	434,987,000
Change	10,747,000	13,480,000	18,987,000	12,173,000	19,276,000	22,184,000	16,459,000	21,799,000	24,326,000	30,656,000	38,136,000	15,573,000	29,364,000	31,791,000	37,657,283
End	140,783,000	154,263,000	173,250,000	185,423,000	204,699,000	226,883,000	243,342,000	265,141,000	289,467,000	320,123,000	358,259,000	373,832,000	403,196,000	434,987,000	472,644,283
Plan Fiduciary Net Position															
Beginning	84,992,000	133,905,892	143,524,621	153,275,221	165,299,329	151,836,190	142,436,574	228,630,039	260,638,435	288,238,797	312,334,951	355,591,114	333,244,021	271,188,485	300,042,562
Change	48,913,892	9,618,729	9,750,600	12,024,108	(13,463,139)	(9,399,616)	86,193,465	32,008,396	27,600,362	24,096,154	43,256,163	(22,347,093)	(62,055,536)	28,854,077	54,999,961
End	133,905,892	143,524,621	153,275,221	165,299,329	151,836,190	142,436,574	228,630,039	260,638,435	288,238,797	312,334,951	355,591,114	333,244,021	271,188,485	300,042,562	355,042,523
Net Pension Liability															
Beginning	(45,044,000)	(6,877,108)	(10,738,379)	(19,974,779)	(20,123,671)	(52,862,810)	(84,446,426)	(14,711,961)	(4,502,565)	(1,228,203)	(7,788,049)	(2,667,886)	(40,587,979)	(132,007,515)	(134,944,438)
Change	(38,166,892)	3,861,271	9,236,400	148,892	32,739,139	31,583,616	(69,734,465)	(10,209,396)	(3,274,362)	6,559,846	(5,120,163)	37,920,093	91,419,536	2,936,923	(17,342,678)
End	(6,877,108)	(10,738,379)	(19,974,779)	(20,123,671)	(52,862,810)	(84,446,426)	(14,711,961)	(4,502,565)	(1,228,203)	(7,788,049)	(2,667,886)	(40,587,979)	(132,007,515)	(134,944,438)	(117,601,760)
PENSION OBLIGATION BONDS															
Beginning	0	30,720,000	30,360,731	30,926,625	29,921,625	27,375,000	25,720,000	104,495,000	102,270,000	99,930,000	97,475,000	94,890,000	92,160,000	89,275,000	86,220,000
Change	30,720,000	(359,269)	565,894	(1,005,000)	(2,546,625)	(1,655,000)	78,775,000	(2,225,000)	(2,340,000)	(2,455,000)	(2,585,000)	(2,730,000)	(2,885,000)	(3,055,000)	(3,240,000)
End	30,720,000	30,360,731	30,926,625	29,921,625	27,375,000	25,720,000	104,495,000	102,270,000	99,930,000	97,475,000	94,890,000	92,160,000	89,275,000	86,220,000	82,980,000
COUNTY DEBT															
Balance of Unfunded Pension-Created Liabilities															
Net Pension Liability	6,877,108	10,738,379	19,974,779	20,123,671	52,862,810	84,446,426	14,711,961	4,502,565	1,228,203	7,788,049	2,667,886	40,587,979	132,007,515	134,944,438	117,601,760
Pension Obligation Bonds	30,720,000	30,360,731	30,926,625	29,921,625	27,375,000	25,720,000	104,495,000	102,270,000	99,930,000	97,475,000	94,890,000	92,160,000	89,275,000	86,220,000	82,980,000
Total	37,597,108	41,099,110	50,901,404	50,045,296	80,237,810	110,166,426	119,206,961	106,772,565	101,158,203	105,263,049	97,557,886	132,747,979	221,282,515	221,164,438	200,581,760
All Other Balance Sheet Liabilities	28,283,917	24,507,843	23,528,453	21,620,810	41,778,734	42,946,599	46,831,986	46,248,234	44,340,679	46,495,615	45,068,544	46,212,730	46,523,232	43,689,125	42,570,585
Total Liabilities (Doesn't include retiree healthcare)	65,881,025	65,606,953	74,429,857	71,666,106	122,016,544	153,113,025	166,038,947	153,020,799	145,498,882	151,758,664	142,626,430	178,960,709	267,805,747	264,853,563	243,152,345
Balance of Unfunded Pension-Created Liabilities															
Net Pension Liability	10%	16%	27%	28%	43%	55%	9%	3%	1%	5%	2%	23%	49%	51%	48%
Pension Obligation Bonds	47%	46%	42%	42%	22%	17%	63%	67%	69%	64%	67%	51%	33%	33%	34%
Total	57%	63%	68%	70%	66%	72%	72%	70%	70%	69%	68%	74%	83%	84%	82%
All Other Balance Sheet Liabilities	43%	37%	32%	30%	34%	28%	28%	30%	30%	31%	32%	26%	17%	16%	18%
Total Liabilities (Doesn't include retiree healthcare)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%

The first 3 sets of 3 rows show the Balances and Changes in Total Pension Liability, Plan Fiduciary Net Position, and Net Pension Liability. The fourth set of 3 rows shows the balance of Pension Bonds. The first Bonds were sold in December 1996 (in fiscal year July 1996 – June 1997) and the second in December 2002.

Note the increase in Pension Bond debt in fiscal year 1999. There is an inconsistency in County financial statements at that point; Pension Bond debt actually appears to increase. We don't know why – but the change in the long term finances of the County isn't very significant.

Without question unfunded pension created debt dominates Mendocino County's liabilities. (Note – this graph doesn't include unfunded retiree healthcare – a whole other very complex issue beyond the scope of this effort.)

From 1997 through 2011 all other debt reported on the balance sheet (Statement of Net Assets) increased about 50%. Unfunded pension debt (Net Pension Liability and Pension Bonds) increased 435%. For every $1 increase in other debt unfunded pension debt increased about $9.

In 1997 the County's debt was about 57% unfunded pensions (including Pension Bonds) and 43% all other, but by 2011 the proportion had shifted to 82% unfunded pension-created debt and 18% all other.

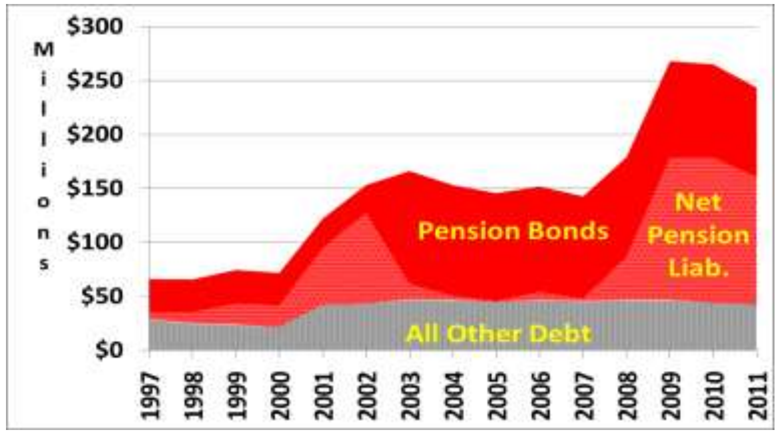

Figure 1 – Growth of Mendocino County Debt

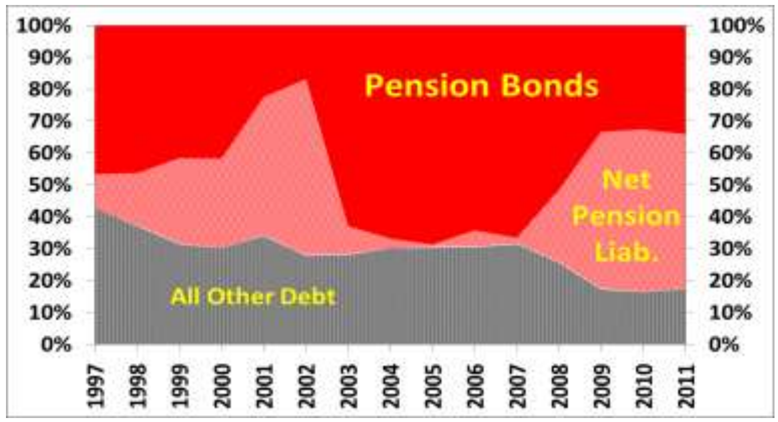

Figure 2 – Composition of Mendocino County Debt

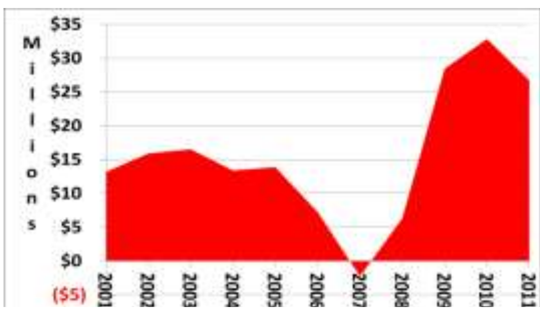

Figure 3 – Interest Expense Including GASB 68

VIII. So - What's The Big Deal about GASB 68?

A. Real Information

GASB's old standards hide the huge financial problems that caused today's destructive levels of unfunded retiree benefit debt in many local and state governments. They allow governments to report the pension expenses that occurred in the past that created unfunded pension debt over 35 or more years in the future. In effect these standards seem to want us to believe that the pension expenses that created unfunded pension debt are created as the debt is paid – which is absurd. GASB's current standards also obscure those expenses by combining tiny portions of unreported pension expenses from dozens of previous years with current year pension expenses, and provide absolutely no clue about what specifically is going wrong.

When governments finally implement GASB's new standards they will be forced to expose many of the most powerful financial dynamics of guaranteed pensions. The people will finally see the scale of true economic deficits that many if not most local and state governments have produced. The people will be shocked by what they will then realize is the extent of change necessary in these distressed governments.

B. What Caused the Unfunded Pension Debt?

In our experience very few if any local government officials we've observed have anything approaching a working understanding of the math and financial dynamics of "Actuarial Science". Actuarial Reports don't help – they rarely convey what's really happening to the finances of troubled Pension Funds to decision makers or anyone else. Even highly experienced financial professionals in other fields struggle to interpret Actuarial Reports in ways that can lead to targeted corrective action.

GASB 68 will make it far more possible to understand what's going on and what needs attention by making three big changes.

- Expenses will (mostly) be reported in the year they occur instead of being spread out over as many as 35 years.
- Today's undifferentiated "generic pension expense" will be separated into several discrete groups of issues and the finances of each group will be quantified.
- By requiring governments to provide 10-year schedules of the changes in Net Pension Liability in the footnotes to their financial statements people will see long-term trends driving their governments' pension expenses and debt.

This section shows some of the analysis made possible for the first time by GASB 68.

1. Financial Impact of Guaranteed Return on Investment

Governments with defined pension benefits essentially provide guarantees to their employees and retirees that investment returns will at least equal their target rates of return. During these years Mendocino County's rate was 8% (since lowered to 7.75%). If the Pension Fund fails to earn that rate the County is legally obligated to contribute extra funds to make it up. But under today's reporting standards the annual expense of that guarantee is completely hidden. It is reported as part of "generic" pension expense over 30 years as the County pays the debt created by the shortfall. But the financial truth is the County incurs that obligation – and expense - each year earnings fall short.

This shows one aspect of the result for Mendocino County of that guarantee.

	2009	2010	2011	Total 3 Years
Changes in Net Assets				
Interest (Annual Cost to County of Guarantee)	29,060,847	31,348,044	33,945,410	94,354,301
Net Investment Income	(53,511,078)	38,128,443	64,075,101	48,692,466
Net Shift to County	(82,571,925)	6,780,399	30,129,691	(45,661,835)

The Interest is the cost to the County of its guarantee to employees and retirees. If earnings are less the County goes into debt (all other things being equal). Over these four years the earnings shortfall drove the County $46 million deeper into debt. But what would happen if the Pension Fund earned exactly its target rate of return on its investments?

	2009	2010	2011	Total 3 Years
Expected Return	26,278,512	21,494,203	23,640,399	71,413,114
Interest (Annual Cost to County of Guarantee)	29,060,847	31,348,044	33,945,410	94,354,301
Difference	(2,782,335)	(9,853,841)	(10,305,011)	(22,94187)

The Pension Fund is "underfunded" – it only had about 70% of the money it was supposed to have over these 3 years (even though it borrowed a total of 110 million to fill previous deficits in the Pension Fund by selling Pension Obligation Bonds in 1996 and 2002.) It can't make investment returns on money it doesn't have. This creates a type of "structural" deficit. Even if it exactly earns its target it would have gone more than $20 million more into debt.

This shows the contribution of investment activity to the County's pension expense under GASB 68.

	2009	2010	2011
Part of Pension Expense			
Interest	29,060,847	31,348,044	33,945,410
Expected Return	(26,278,512)	(21,494,203)	(23,640,399)
Difference Expected v. Actual Return (5 years)	19,232,285	16,773,437	10,437,913
	22,014,620	26,627,279	20,742,924

The yearly interest charge – the cost of the County's guaranteed investment return to its employees and retirees – increases the County's yearly pension expense each year. But unlike how GASB calculates the shift in Net Pension Liability, when calculating pension expense GASB 68 requires us to separate investment returns into two parts – expected returns and the difference between expected and actual returns.

Expected returns decrease pension expense. Then each year's difference between actual and expected returns is recognized over 5 years – the values above are the sum of 20% of that difference for each year and the previous four years. This prevents chaotic and confusing shifts that would result if the actual return were used. GASB 68 will show **the County's expense for guaranteeing investment returns over these three years was about $23 million a year or about $70 million over these three years**.

2. Expected v. Actual Experience & Assumption Changes

Although the "interest rate assumption" (aka "target rate of investment return") is the most powerful variable in pension finance math Actuaries must make dozens of other assumptions and projections, all of which can be wrong and in fact given the complexity of pension finance are always more or less wrong. The list of such assumptions is enormous, including mortality projections by age, sex, job categories, etc., retirement – termination – and disability rates, investment expenses, Pension Fund administrative expenses, salary increase rate, cost of living increases, proportional choice of "alternative" methods to receive pension benefits, and on and on.

GASB 68 requires information be shown about the impact of the difference between the projected and actual values of all these other Actuarial assumptions in two ways. First – the Schedule of Change in Net Pension Liability shows the change that occurs in each year. Second - GASB will require those yearly changes to be included over the average number of years of remaining service by employees including inactive and retired employees. Our model assumes this amortization period is 8.25 years.

Table 2 – Expected v. Actual Experience & Assumption Changes

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
TOTAL PENSION LIABILITY										
Expected v. Actual Experience & Assumption Changes	4,761,829	(2,815,914)	2,746,909	4,992,149	10,118,390	14,417,899	(8,837,696)	2,588,961	6,040,393	11,025,035
Pension Expense Under new GASB Standard										
Expected v. Actual Experience & Assumption Changes		2,331,417	2,721,880	3,162,129	3,878,978	4,725,474	3,374,571	3,462,590	3,689,885	5,137,947
Balance Deferred to be Included in Future Pension Expense		7,699,869	7,724,898	9,554,917	15,794,330	25,486,755	13,274,488	12,400,859	14,751,367	20,638,455

We have enough data back to 1995 to calculate the amount of change in Total Pension Liability that would be ascribed by GASB 68 to these two variables (combined in our model into one variable). We can show changes for the full ten years in this model (the first data row).

But it takes 8.25 years for each year's change to be incorporated into pension expense starting with the year the change is identified. Therefore the first year we can project how much these variables contribute to pension expense is 2003. (This is shown in the second row of data.)

The last data row is the total accumulated deferrals of this variable over the immediately preceding years that have not yet been incorporated into pension expense.

It's extremely important to observe that although changes in these variables reduced Total Pension Liability in two of these ten years (without considering the impact of the other variables that change Total Pension Liability) the cumulative impact over the years is to increase Pension Expense reported each year between about $2½ million to a little over $5 million. And the trend of accumulated deferred changes has increased over these years so that we can anticipate the contribution to future year Pension Expense is likely to be larger than in the past.

WHY?

GASB 68 only provides the data that should lead to this question – it's up to government financial officials, executives, governing bodies, representatives of employees and retirees, creditors, and the public to demand clear and believable answers to this question.

But at least now the question can be asked with some degree of numeric specificity.

3. Unexplained Changes in Plan Fiduciary Net Position

Plan Fiduciary Net Position in layman's terms is essentially the net value of Pension Fund Assets. The calculation of changes in this Net Position as shown in the illustration in GASB 68 is (using 2009 values in the illustration):

"Other" is GASB's "catch-all" category for changes in Net Pension Liability not covered by the other categories. We already know the value of beginning and ending Plan Net Position and the values of all other variables EXCEPT for "other". In our model it's the amount necessary to compute the ending plan position.

Over the 10 year illustrated Schedule of Changes in Net Pension Liability in GASB 68 the total change is $185 million of which negative $478K was "Other" - ½% of the total change.

For Mendocino total "Other" changes in Plan Net Position for 10 years is $13 million - 6½% of the total change of $203 million.

Again – as with unexplained large values in Expected v. Actual Experience & Assumption Changes above several of these values are simply too large not to be explained. Are they errors in MendoCERA financial statements (there is a history of uncorrected significant errors)? Or should they be in other categories?

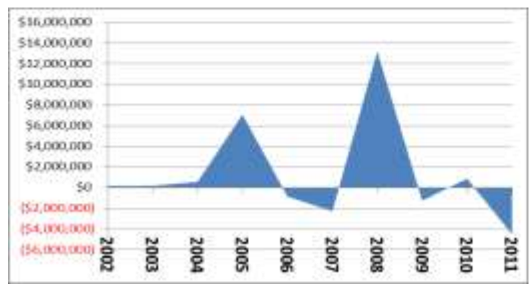

Figure 4 – "Other" Changes in Plan Net Position – Mendocino County

Once again –GASB 68 won't produce the answer to the question, but it will provide the data needed to ask it.

4. Contributions & Benefits Paid

Table 3 – Contributions and Benefits Paid – Mendocino County – 10 Years

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total	10 Year Change
Contributions - Employers												
Pension Contributions	6,348,000	6,663,000	2,619,540	1,513,870	3,946,840	7,533,000	7,232,000	8,524,860	8,234,253	9,553,955	67,262,333	131%
Unfunded Pension Amortization Payments										5,093,015		
Diversion of Pension Contributions to Pay Healthcare			1,728,689	2,662,304	1,739,719						6,130,712	
POB Proceeds	0	76,299,000	0	0	0	0	0	0	0	0	76,299,000	
Contributions - Employees	4,334,027	5,341,060	6,648,590	6,617,782	5,998,176	6,002,259	6,612,780	6,836,202	6,502,080	5,446,964	60,339,920	26%
Pansion Payments (incl. refunds)	(9,401,023)	(10,315,561)	(10,961,992)	(12,202,444)	(13,945,791)	(15,188,645)	(16,814,287)	(17,646,870)	(20,333,770)	(22,314,081)	(149,124,464)	137%
Payment of Retiree Healthcare from Pension Funds	(2,295,076)	(2,256,850)	(2,758,826)	(2,680,365)	(3,410,319)	(3,382,351)	(3,950,000)	(4,399,000)	(3,896,000)	(1,709,166)	(30,737,953)	-26%

This shows the County's and its employee's contributions as well as benefits paid over these 10 years. Although GASB 68 doesn't require this "break out" of employer contributions and benefit payments we believe this extra detail is important for officials to see and for the public to be able to hold those officials accountable.

In 2004 through 2006 the County paid the Pension Fund what the Fund's Actuary required, but the Pension Fund (with the agreement of County officials) diverted over $6 million of the pension contributions to pay retiree healthcare. (I believe this is a direct violation of several laws.) Then in 2011 the County for the first time started to pay unfunded pension amortization payments. Twice before instead of making these types of payments the County borrowed Pension Bonds in fiscal year's 1997 and 2003 (the sale of Bonds occurred in December of 1996 and 2002).

The County's pension contributions grew from $6.3 million in 2002 to $14.6 million in 2011 – a 131% increase. In contrast employee contributions grew from $4.3 million to $5.4 million – only a 26% increase. The County's contributions grew at a rate 5 times greater than employee contributions.

In 2002 the County paid $1.46 to the Pension Fund for every $1.00 paid by its employees. In 2011 it paid $2.69 for every $1.00. The County pays a significant amount of the Deputy Sheriff's contributions but that amount isn't included in these ratios. We believe GASB 68 should have required governments to report how much employee contributions the government pays on their behalf. Mendocino County pays a large portion of its Deputy Sheriff's contributions. But that information isn't published in regular County or MendoCERA reports.

Pension payments increased from $9.4 million to $22.3 million – an increase of 137%. Total contributions (County and employee) increased only 88%.

But in addition to pension payments the Pension Fund also paid nearly $31 million in retiree healthcare benefits over these 10 years. (The Pension Fund began to significantly reduce healthcare payments during 2011.) The County never really paid any part of these payments despite reporting it contributed to retiree healthcare in 2004 and 2006. By diverting money out of its pension contributions (or agreeing to allow MendoCERA to do so) it simply increased its unfunded pension debt. Dollar for dollar MendoCERA's payments of retiree healthcare over the past two decades simply increased the County's debt.

In 2002 contributions (County + employee) were $10.7 million and benefit payments (pensions and healthcare) were $11.7 million – one million more.

In 2011 contributions were $20.1 million and benefit payments were $24 million. But there were two big shifts over the previous year. First, the County was required to start making very significant unfunded pension elimination payments in 2011, and second, the Pension Fund began to significantly cut retiree healthcare payments. In 2010 total contributions were $14.7 million whereas benefit payments were $24.2 million – nearly $10 million more.

- County pension contributions grew significantly faster than employee contributions (and this doesn't include the impact of the County paying a significant portion of Deputy Sheriff contributions).
- Benefit payments have also grown faster than total contributions.

These are not "good" trends. Officials should demand explanations and projections of where these trends are heading over the next 10 years.

5. Pension Fund Administrative Expenses

The administrative expenses of the Pension Fund are not as large as other sources of the County's unfunded pension debt such as the costs of the County's guarantee to employees and retirees of a minimum return on investment and unexplained negative variances in both other actuarial assumptions and other changes in Plan Net Position. However, every dollar paid to support the administrative structure of MendoCERA increases the County's pension debt.

GASB 68 will force these administrative expenses to be clearly identified in the calculation of changes in Net Pension Liability. It is thereby also clearly identified as part of the County's annual pension expense. Figure 5 shows MendoCERA Administrative expenses since 1995. In the 10 year period 2002 through 2011 these expenses grew 225%.

By law counties have no direct control over these expenses of their independent Pension Funds. However, these expenses directly increase county Net Pension Liability dollar for dollar. Clearly it's in the interest of counties to question Pension Fund administrative expenses. And even if County Boards of Supervisors and Executives and Auditor-Controllers can't directly hold Retirement Boards accountable they can certainly use their "bully pulpits" to let the people know when Retirement Boards are "wasting the people's money".

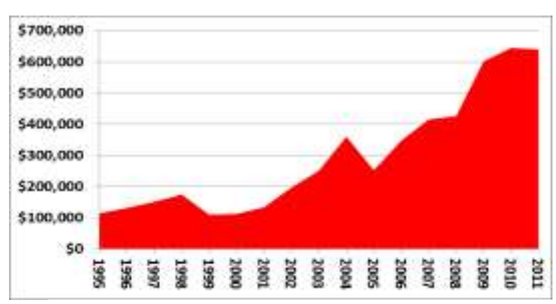

Figure 5 – Pension Fund Admin Expense Mendocino County

(Now – it's also true that sometimes you get what you pay for. MendoCERA created at least $200 million of debt for the people of Mendocino County. How much would it have been worth for that debt to not have been created? Obviously – many millions of dollars. It's beyond the scope of this paper to delve into the failures of County Retirement Boards in California – but they have been massive. One of the major problems facing most of these 21 counties is very poor performance of their Retirement Boards and a near lack of effective accountability imposed on those Boards.

A major potential benefit of the increased information GASB 68 will produce is greatly enhanced accountability of County Retirement Boards. Their feet should be held to the fire – even if County officials can't directly hold Retirement Boards accountable they can demand answers and inform the people of failings.