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GASB Changes Pension Accounting: Significant Reporting Changes, but Not Funding

In 2012, the Government Accounting Standards Board (GASB) released new reporting standards for public pension plans and participating employers. The new standards will soon affect public employers' financial statements as GASB Statements No. 67 and No. 68 will replace GASB Statements No. 25 and No. 27. GASB Statement No. 67 (which applies to financial reporting of most pension plans) was effective for plan fiscal years after June 15, 2013, and GASB Statement No. 68 (which applies to most public employers who provide pensions) went into effect for plan fiscal years after June 15, 2014.

Key Points

- Accounting and funding will be getting a 'divorce',
- GASB rules do not affect plan funding, an employer's budget, or cash disbursements,
- GASB rules create a carrot-and-stick incentive to make actuarially determined contributions,
- Some employers in multi-employer plans may try to exclude workers from the plan to manipulate their books and skirt costs if State rules allow it, and
- The new rules endorse using investment returns for discounting future costs.

What to Know About the Major Changes

The biggest change for the public pension community is likely the 'divorce' between funding and accounting. GASB sets rules for accounting and financial reporting. **Nothing in GASB's changes require plans to change their funding methods or assumptions**. While these two standards worked in harmony for many years, plans will now have two sets of numbers. Financial statements previously reported key funding figures such as the *annual required contribution* (ARC) and *unfunded actuarial accrued liabilities* (UAAL). While plans will continue to develop and utilize their own funding methods, they will be required to use GASB standards for financial reporting.

The new GASB reporting figures will include the *total pension liability* (TPL) and the *net pension liability* (NPL). While conceptually similar to the accrued and unfunded liability concepts, these new measures vary in important ways. First, a plan that is projected to deplete its assets will have to use a *blended discount rate*, which uses a market-based municipal bond rate in addition to the expected return on assets. We do not expect to see the blended discount rate used where actuarially determined contributions are regularly contributed, as those plans will not project assets to be depleted. Where contributions are determined by statute, or if a state or employer has a history of not making their full contributions, plans may have to use the blended discount. This carrot-and-stick approach encourages decision-makers to utilize actuarially sound contribution strategies.

Plans will be required to use the *entry age normal cost method* for the TPL and NPL. Most public sector plans already use entry age normal, but the requirement will further standardized reporting.

GASB standards will create a new "pension expense" for reporting, but it will not change required or actual plan contributions. Plans will no longer simply report the ARC figure as a pension expense. In fact, the new pension expense will be far too volatile to use for funding purposes. Therefore, we will see two different figures representing the annual pension cost: the actual cash/budget cost (the contribution amount) and a new accounting cost as required under GASB.

Other reporting changes include using the market value of assets instead of the actuarial value of assets. Reporting rules will also severely limit allocating costs over long timeframes. For instance, investment gains and losses (compared to expectations) must be recognized within five years and the entire cost of some benefit modifications, such as ad-hoc COLA's, must be recognized in the next year. Therefore, those amounts will be highly volatile as plans will not be able to amortize such changes over 20-30 years, as many do for funding purposes.

Cost Sharing in Multi-Employer Plans
Most NEA members participate in large state-wide multi-employer plans. In the past, participating employers did not recognize their share of unfunded liabilities on their books; instead they showed historical contribution trends. GASB will now require that unfunded liabilities be allocated to participating employers based on their share of plan contributions. The new standards create incentives for participating employers to exclude groups of workers from these plans in order to shift past service costs. Trustees should be aware of the possibility that some will try to *shift, reduce, or eliminate their obligations* by excluding workers from the plan.

Additional Disclosures
GASB's new rules also include additional disclosures and more historical information. For instance, plans will be required to show a 10-year history of their "money-weighted" rate of return, employer contributions, and changes to the NPL. The rule will be applied prospectively, so it is not necessary to recalculate this information for prior years if the information is unavailable.

Here are some other key facts that address common misperceptions:

- GASB will not change the discount rate for all plans, even for reporting.
- GASB will impact financial reporting, but not participating employers' budgets.
    - While critics are sure to misuse this new information, it's important to recognize that the cash requirements will not change unless the plan changes funding methods.
- If a plan uses the blended discount rate, it does not mean the plan will run out of money. It does mean that current projections indicate that some future adjustment(s) may be needed to keep the plan solvent. The adjustment may simply be contributing the full ARC.
- GASB did not embrace pension critics' argument that funding discount rates are wrong. In fact, they endorsed the concept by using the funding discount rates in situations where future contributions are projected to be adequate. GASB only utilizes the blended discount rate when projections indicate contributions are inadequate, treating excess obligations like municipal debt. Changing funding practices can eliminate the use the blended discount rate.

Change is an Opportunity
Given the divorce between accounting and funding, this may be a *good opportunity for trustees to discuss and review the plan's funding strategy with the actuary*.

Frequently Asked Questions

Q1. How might employers use this information during bargaining?

A1. Employers may try to claim that the liability reported on their balance sheet is new and a signal that costs have increased. This liability is not new. As GASB has noted, the liability has long existed and is simply being reported on the balance sheets of participating employers. It has no impact on actual employer costs, which will continue to be the annual contributions to the plan.

Q2. Are reporters likely to misunderstand this new information and, if so, how?

A2. It is likely that reporters will believe that unfunded pension obligations have grown significantly in some states, as they compare the NPL as the new unfunded liability number. The unfunded obligations are still determined under the funding rules, and the NPL is not an apples-to-apples comparison to the unfunded liabilities of prior years. The difference between next years NPL and last year's unfunded liabilities may be mostly due to accounting method changes, not actual plan experience. It is very likely that plans will continue to develop the same unfunded liability figure for funding purposes, and that it can be found in the actuarial report. That comparison will give you a better sense of what happened during the year.

Q3. Which unfunded liability figure is correct in describing the plan's fiscal status?

A3. Both figures are legitimate, and both figures represent different ways to see the same concept. For plan funding purposes and evaluating the financial cost, the funding numbers are the key consideration for us. To understand the long term trends of funding the plan, the funding results are again the key figures. However, bond rating agencies will likely focus more on the accounting results that punish employers who are not making sound actuarial contributions and where market interest rates are factored in. Thus, accounting results will likely have a larger impact on bond ratings.

Q4. Are governmental agencies' bond ratings going to be cut dramatically once the new GASB standards impact financial statements?

A4. We do not expect a dramatic change in bond ratings. Ratings agencies have already considered this issue. Ratings agencies do expect to modestly change some ratings, with both improvements and cuts, but they have been aware of funding habits and had considerable information in prior reporting. We do not expect that the ratings agencies will be caught off-guard regarding the impact the new standards will have on these financial figures. The ratings agencies also know that bond defaults continue to be extraordinarily low, even despite the difficulties of the past few years and the few high-profile instances.

Q5. GASB standards seem to affect appearances more than actual employer finances, is that true?

A5. Yes, since GASB affects reporting, not funding. To understand the year to year financial cost to employers, we should focus on the funding results. For instance, if interest rates rise from their current historic lows, it might cause a plan's accounting result to improve dramatically. For funding and cash cost purposes, the actuarially required contribution remains the key issue for employers. So, it is possible that GASB results will improve even as contributions rise, which is not good news for employers who must pay the increased contribution rate.

For further information or assistance, please contact Dan Doonan at NEA Collective Bargaining and Member Advocacy at ddoonan@nea.org or 202-822-7519.