New GASB Rules to Affect Pension Reporting

July 2012

Two final rule changes could add massive liabilities to city financial statements as well as force up pension costs at a time when public employers are struggling to pay continually increasing contribution rates.

In June 2012, the Governmental Accounting Standards Board (GASB) approved amendments to two current statements dealing with accounting and financial reporting of pension plans. The Governmental Accounting Standards Board (GASB) is the independent nonprofit organization that establishes and improves standards of accounting and financial reporting for state and local governments.

These two new statements – No. 67 and No. 68 – would amend GASB Statements No. 25, No. 27 and No. 50. Statement No. 67 deals with financial statements of pension plans, while Statement No. 68 deals with financial statements of covered employers, such as cities. Statement No. 67 will take effect in FY 2014, and Statement No. 68 will take effect in FY 2015, although GASB encourages plans and governments to implement the new standards earlier.

Changing Employer Financial Statements

One of the underlying premises of the changes is that pensions are a form of compensation, like salaries. And, like salaries, the costs and obligations associated with pensions should be recorded as they are earned by employees. This is different from the current practice, where the costs and obligations are recorded when contributions are made by the government or benefits are paid to retirees. In other words, GASB is redefining a pension obligation as a liability.

GASB notes that pensions that are earned today will not be received by the employees until they retire. That means governments have an obligation now to provide those benefits at a future time. So, GASB believes that the net pension liability – the difference between the system's overall obligation and the system's assets – needs to be reported on the government's financial statements.

> "The new standards will improve the way state and local governments report their pension liabilities and expenses, resulting in a more faithful representation of the full impact of these obligations.
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> "Among other improvements, net pension liabilities will be reported on the balance sheet, providing citizens and other users of these financial reports with a clearer picture of the size and nature of the financial obligations to current and former employees for past services rendered."
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> *GASB Chairman*
> *Robert H. Attmore*
> *June 2012*

All Kentucky cities with a defined benefit pension plan are enrolled in the County Employees Retirement System (CERS). (Note: Only Lexington's non-hazardous duty employees are in CERS; police and fire employees are in their own local fund.) CERS operates as a cost-sharing multiple-employer plan. In this type of plan, governments share the costs and risks of both providing benefits and administering the plan. Any assets in the plan may be used to pay any retiree's benefits, regardless of what participating agency the employee worked for or retired from.

Even though CERS is a cost-sharing multiple-employer plan, GASB believes that the needs of users of financial information of governments participating in this type of plan is not significantly different than the needs of users of financial information from other types of pension plans. As a result, the Kentucky Retirement Systems (KRS) will have to calculate the net pension liability for agencies in CERS, and cities will have to report that liability on their financial statements.

This move would prominently place retirement unfunded liability on the employers' balance sheets instead of just the retirement system's financial statements. Preliminary estimates based on the FY 2011 actuarial analysis and same-year agency contributions show that the new rule could add $2.3 billion in liabilities collectively to city financial statements. Louisville and Lexington would have to account for around $823 million and $191 million, respectively, on their financial statements.

These changes could have serious implications with debt-rating agencies since many cities will appear financially insolvent. Debt-rating agencies may significantly lower the credit rating of cities, and financial institutions will likely increase lending costs to cover the increased "risk." These factors will mean higher borrowing costs for major projects.

Employers will also be required to provide substantial additional disclosures on their financial statements. Each CERS participating agency would be required to include information about the plan as a whole. This includes net pension liability, the effects of benefit changes, changes of actuarial assumptions and more.

Top 20 Cities with the Most Estimated Unfunded Liability to Add to Financial Statements

City	Estimated Total New CERS Liability on Financial Statements
Louisville	$823 million
Lexington	$191 million
Covington	$75 million
Bowling Green	$67 million
Owensboro	$57 million
Paducah	$48 million
Frankfort	$48 million
Ashland	$40 million
Henderson	$38 million
Hopkinsville	$36 million
Madisonville	$36 million
Florence	$35 million
Elizabethtown	$33 million
Richmond	$31 million
Somerset	$30 million
Nicholasville	$30 million
Georgetown	$23 million
Newport	$22 million
Jeffersontown	$22 million
Winchester	$22 million

KLC has prepared estimates of the financial statement impact for all cities participating in CERS. These estimates are based on the 2011 actuarial analysis. Future analyses may be considerably different due to system assumptions and liabilities.

Each agency will also be required to report the plan's total liability, net position, covered-employee payroll, ratio of net pension liability to payroll and more. These would be presented both for the participants of CERS as a whole and for the agency's proportionate share of the aggregate amounts.

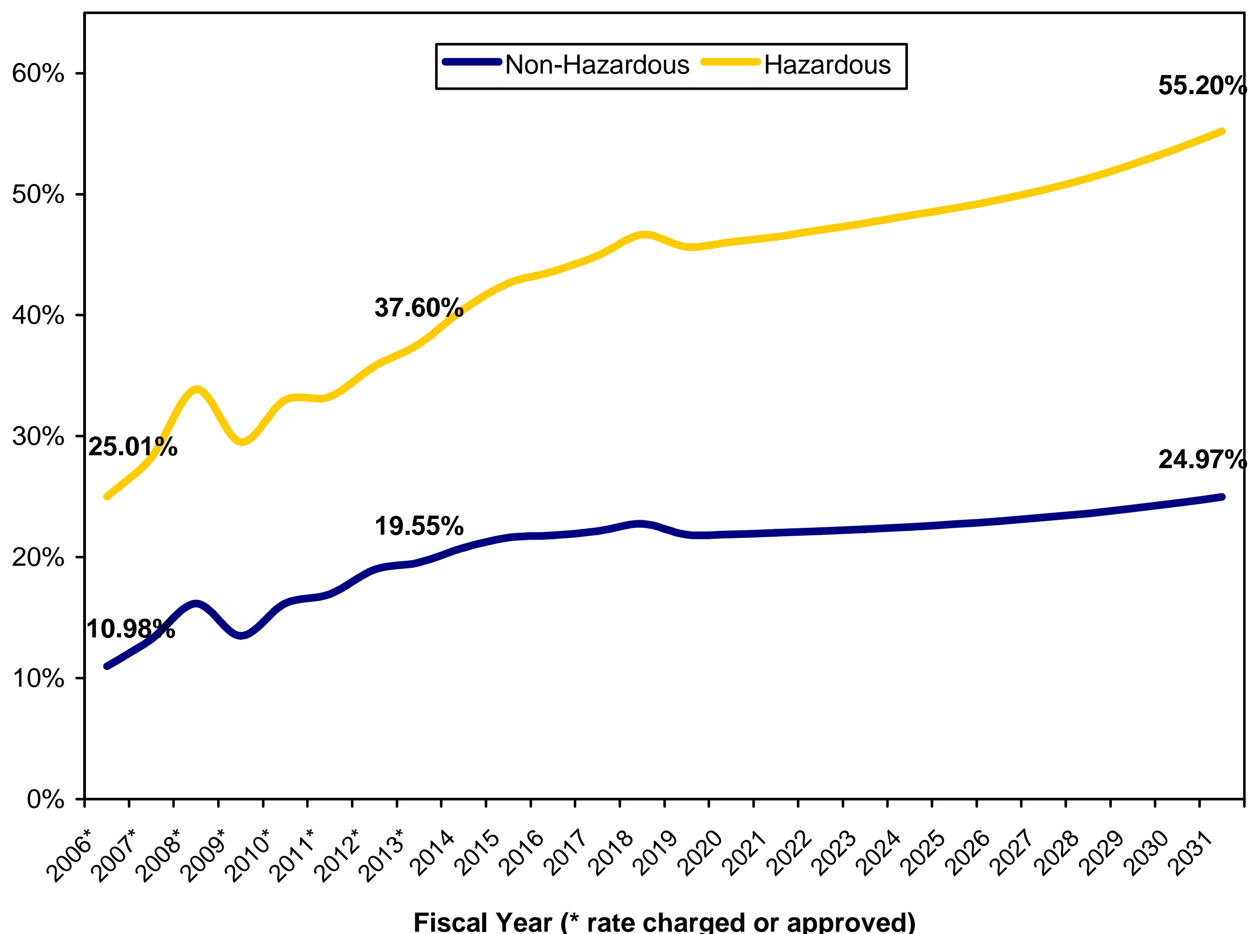
Increasing Pension Costs

GASB also addressed the discount rate, or the assumed rate of return on investments, in these rule changes. The discount rate is one of the most important factors used to determine a plan's total future liability. Current standards require governments to apply a discount rate that is equal to the expected future rate of return on the long-term investments of the pension plan. The KRS Board of Trustees and actuary currently use an assumed investment rate of return of 7.75 percent for CERS.

GASB is changing the way retirement systems calculate their long-term assets by changing the discount rate used. If plan assets related to current employees, retirees and their beneficiaries are projected to be sufficient to make the estimated benefit payments for those individuals, then the discount rate would not change. However, at the point where plan assets are projected to not be available for long-term investment, the system must incorporate into the discount rate a tax-exempt, high-quality 20-year general obligation municipal bond index rate. The idea is that if the funds can only be put in short-term investments due to short-term liabilities, then a short-term rate of return should be applied to those funds. Currently, those short-term rates are around 3.5-4.0 percent.

If necessary to use a blended rate – a discount rate that combines the 7.75 percent long-term rate of return with the municipal bond index rate – then assets would be valued lower. As a result, employer contributions would need to increase to cover the additional unfunded liability.

The new rules also shorten the amortization periods and eliminate the smoothed market valuation. According to the Cavanaugh Macdonald Consulting, the KRS actuary, these changes would likely lead to higher, more volatile pension expenses for CERS members.



Source: Kentucky Retirement Systems, January 2012

Compounding Retirement Problems

These new GASB rules come at a time in which CERS employer contribution rates continue to climb. The Kentucky Retirement Systems Board of Trustees approved FY 2013 contribution rates of 19.55 percent and 37.60 percent for non-hazardous and hazardous duty, respectively. Just 10 years ago those rates were 6.34 percent and 16.28 percent.

In 20 years, the non-hazardous duty CERS employer contribution rate currently is projected to be over 24 percent, while the hazardous duty rate will be over 53 percent. With increased volatility in pension expenses, these rates will likely increase year after year without significant structural benefit changes.

Questions? Contact the KLC research team at 1-800-876-4552.