OKLAHOMA MUNICIPAL LEAGUE, INC.
MUNICIPAL POLICY REVIEW

Champions For Effective Local Government

201 N.E. 23rd STREET ◆ OKLAHOMA CITY OKLAHOMA 73105

405-528-7515 ◆ 800-324-6651 ◆ 405-528-7560 Fax

No. 37 August 24, 2011

The Governmental Accounting Standards Board (GASB) is proposing changes to pension accounting standards that would require the reporting of net pension liability on your financial statement. These changes affect the way municipalities calculate their total pension liability and pension expenses. This calculation includes your municipality's share of the State's Firefighter and Police Officer pension plans. **These changes could result in increased unfunded pension liabilities.**

Given that the proposal impacts benefits offered to municipal employees and retirees, there is reportedly a parallel study project for post-employment benefits (OPEB) that may follow the same or similar standards. If implemented this could impact compensatory time banks, retiree health coverage mandated by 11 O.S. Section 23-108 and potentially other similar "unfunded" or future liabilities.

A non-technical version of the proposal is available at www.gasb.org. In addition, you can view an archived GASB webcast available on the GASB Home Page for additional information. Comments can be made on this website until September 30, 2011.

The following was prepared for the League by Crawford and Associates. We thank Mike Crawford and Marcy Twyman for their collaborative effort to bring their expertise forward to benefit our members.

ACCOUNTING FOR PENSION PLANS IS GETTING A FACELIFT

By: Crawford and Associates

How pension plan obligations are reported in governmental financial statements is about to get a major facelift – and likely not a very pretty one for most plans or employers. After much research and deliberation, the Governmental Accounting Standards Board (GASB) released its proposed changes to pension accounting standards on July 8, 2011—just weeks before major upheaval on Wall Street. If adopted as proposed, it would mean a whole new look for financial statements of not only the employers who provide these plans but also the plans themselves.

While the proposed new GASB standards would result in significant changes in the accounting and reporting of pension obligations, it does not require governments to make changes in how they fund such obligations. "Users of state and local government financial reports have told the GASB that current standards do not provide enough information to adequately understand the cost and the liability for benefits promised to active and retired employees," stated GASB Chairman Robert H. Attmore. "The proposals contained in these Exposure Drafts are the result of years of research and extensive deliberations by the Board to address these issues and make financial reporting of pensions more transparent, comparable and useful to citizens, legislators, and bond analysts." Added Mr. Attmore, "It is important to note that these proposals relate to accounting and financial reporting, not to how governments approach the funding of their pension plans. Pension funding is a policy decision made by government officials."

For Oklahoma municipalities, the impact of these changes will vary depending on the type of pension benefits offered to employees and retirees and which basis of accounting is used for financial reporting purposes. Municipalities who offer or participate in defined benefit plans and follow Generally Accepted Accounting Principles (GAAP) will be affected the most; while those who only offer defined contribution plan benefits or prepare cash or modified cash basis financial statements, will not be affected as dramatically.

Pension plans that provide for guaranteed benefits to employees after retirement (defined benefit plans) are the major focus of the proposed revisions. The following summary of the major changes relate to these defined benefit plans and are discussed by basis of accounting used.

GAAP BASIS FINANCIAL STATEMENTS

One of the most noticeable modifications proposed by GASB is the reporting of the unfunded pension liability (in simple terms the difference between accrued pension liability and the fair value of the assets held in trust to pay those benefits). Information that used to be buried in the notes to the financial statements and in supplemental information at the back of the annual financial report, would now be moved front and center on the balance sheet as a liability for all to see.

And for those Oklahoma municipalities who think they're exempt from reporting these large unfunded pension liabilities because they only participate in a cost-sharing defined benefit plan (such as the Oklahoma Firefighters' and Police Pension Plans), think again. The GASB proposal would require reporting (on the balance sheet as a liability) a participating municipality's share of the statewide unfunded pension liability from such cost-sharing plans. This participating municipality's share of the overall plan unfunded obligation is a liability that has never been previously reported anywhere in a municipality's financial statements, even in their footnotes.

Not only is the reporting of this unfunded pension liability changing, but also the way the liability is calculated. And the difference in calculation will likely result in a higher unfunded liability as previously disclosed. That's due to the proposed modifications to the acceptable actuarial cost method and the discount rate allowed to be used to value plan assets. In the past, actuaries have been able to choose from among six different actuarial methods and have generally used the expected long-term rate of investment return to value plan assets. Under the proposed rule changes, GASB will only allow only one actuarial cost method – entry age normal method, and will place limits on the discount rate that can be used to value plan assets. The expected long-term rate of investment return would only be allowed when plan assets are sufficient to fully fund projected benefit payments. When those assets run out, then the rate would switch to a tax-exempt, 30-year rate for municipal bonds—which is generally lower. And that translates to higher net pension liabilities.

Then there is the issue of pension costs. The GASB proposals include changes to recognizing pension costs including the immediate recognition of more components of pension expense than is currently required, including the effect on the pension liability of changes in benefit terms, instead of deferring and amortizing those changes over as many as 30 years. This will likely increase the amount of reported annual pension cost for many plans.

Of course, there are also more note disclosures being proposed—substantially more. For example, the proposals include new requirements for disclosing such additional information as the impact on net pension liability of a one percentage point increase and decrease in the discount rate, and detailed information about changes in the net pension liability for the past 10 years.

CASH AND MODIFIED CASH BASIS FINANCIAL STATEMENTS

For many smaller Oklahoma municipalities who prepare financial statements on a basis of accounting other than GAAP (usually cash or modified cash basis), the rule changes will not have a significant impact.

All the proposed changes regarding changes in the recognition of pension expense in the operating statement and reporting the unfunded pension liability on the balance sheet do not apply to these governments because the true pension expense and net pension obligation are the result of accruals and not cash transactions. Therefore, the reported pension cost on a cash or modified cash basis of accounting will simply continue to be whatever is paid for the employer's contribution and any unfunded actuarial liability for the plan will not be presented on their balance sheets because it does not represent a liability resulting from a cash transaction. For cash or modified cash basis financial statement preparers, the primary impact of these proposed new standards will likely be in the form of expanded footnote disclosures about plan participation and contribution requirements.

WHAT'S NEXT?

There are many users of government financial statements who have praised GASB's efforts to improve the transparency of reporting pension costs and unfunded pension liabilities. In this current economic climate, GASB's timing may be spot-on. However, these proposed changes are not just a simple makeover—they represent major surgery. And as with any major surgery, there is a price to be paid. The cost of actuarial valuations, financial statement preparation and financial statement audits will likely be affected. Are these proposed accounting and reporting changes worth the cost? That is for each financial statement preparer and user to decide. The scalpel hasn't been lifted yet, so there is still time to voice opinions. GASB is accepting written comments through September 30, 2011. They've even written a plain language version of the proposed changes for non-technical financial statement users. If you'd like to read the plain language document and/or respond to the Exposure Drafts, go to www.gasb.org to obtain more information.