GASB Proposes New Accounting Rules for Public Pensions

The Governmental Accounting Standards Board (GASB) proposed on July 8, 2011 changes in pension accounting and financial reporting standards for state and local governments.

The GASB's stated goals are to improve the visibility and quality of pension information in governmental financial statements and to encourage intergenerational equity. The new rules require the following.

- Unfunded pension liabilities will now appear on the employer's balance sheet, rather than in the notes as is now the case.
- Lower actuarial discount rates will apply for most plans, which will increase liabilities and pension expenses.
- Shorter amortization periods will be allowed for unfunded liabilities, which will also increase pension expenses.
- Large pension funds are scheduled to implement new rules beginning in July 2012.

1. Unfunded pension liabilities will now appear on the employer's balance sheet.

a. An employer's unfunded retirement obligations will be reported on its balance sheet, and pension expense will hereafter be reported in the operating statement.

b. Long-term pension liability will be reported like long-term bond debt liability.

c. Annual pension expenses using new GASB calculations will become far more volatile and may be impractical to budget. Many employers will face "sticker shock" if they attempt to fully fund the actuarially calculated cost under these new standards.

2. Shorter amortization periods for unfunded liabilities will increase pension expenses.

a. Amortization of unfunded liabilities, which now can be stretched out over 30 years, will be tightened up significantly.

b. In general, unfunded liabilities may be amortized over the average remaining service lives of incumbent employees, which are usually 12-15 years (one-half of 25-year and 30-year careers and one-half current amortization periods assumed), and certain changes for retirees will be expensed immediately.

c. The net impact overall on current pension solvency analysis is similar to refinancing a 30-year mortgage with a 10-year or 15-year amortizing note; annual payments required to amortize unfunded pension liabilities will go up.

3. Lower actuarial discount rates for most plans will increase liabilities and pension expenses.

a. Where investment fund assets exist to fund all future obligations, the expected investment rate of return used now can continue to be used.

b. Where assets are insufficient — i.e., where investment assets and their earnings will be depleted by the benefits — the effective discount rate for that unfunded portion will be an AA tax-exempt bond index rate (around 5% today).

c. Those two rates will be blended by the actuaries. Seriously underfunded plans, and especially unfunded other post-employment benefits plans, will have the lowest discount rates and thus the (relatively) higher reported liabilities and costs.

d. Example: For a typical pension fund with a 75% funding ratio that is now using a discount rate of 7.5% or 7.75% to calculate its actuarially required contributions, the blended discount rate under the GASB's proposed standard could be reduced by as much as 70 basis points (0.7%). With no change in 30-year amortization, this change in the discount rate would result in a 6% increase in the present value of total liabilities. This appears innocuous enough, but it could result in a 40% increase in annual "catch up" contributions if amortized instead over 15 years.