HOW GASB'S CHANGES WOULD AFFECT A PLAN SPONSOR'S BALANCE SHEET

The current GASB project is not just some "green eyeshade" exercise in technical accounting mumbo-jumbo. On the contrary, requiring a new pension liability number called the "Net Pension Liability," or NPL, to be disclosed on the employer's balance sheet will seriously impair the decision-usefulness of that important document, virtually destroying the ability to use it as a tool for holding plan sponsors accountable for sound funding decisions. By disproportionately increasing the overall employer liabilities by very large amounts, the NPL will also threaten the ability of decision-makers to make the right budget decisions, to the detriment of all generations of taxpayers – current as well as future.

In fact, some experts think ***GASB's proposed changes could "blow-up" an employer's balance sheet***. As demonstrated below, these proposals are expected to have a devastating impact on government employers' ability to balance budgets for decades to come. The employer's balance sheet will become a useless, misleading tool that will confuse the public, mislead investors, and make sound decision-making by elected officials virtually impossible.

Ironically, these changes are being proposed in the name of "improving" a system that is actually working quite well under GASB's current standards. As pointed out in a 2008 Boston College Center for Retirement Research paper[1], "Before the [recent financial] crisis, most public plans were on a path to full funding as recommended by GASB." This has been due in large part to the fact that GASB's current standards for pension accounting for governments "explicitly harmonizes accounting with the actuarial funding characteristics of public pension plans."[2]

But the GASB PV would destroy that harmony by doing away with the one tool currently disclosed in the employers' financial statements -- the "Annual Required Contribution," also known as the ARC -- that has provided policymakers and others with a funding target and a tool to know whether pension plan sponsors are making an effort to pay their fair share of their pension costs. GASB now is proposing that this number should be abandoned, totally disconnecting the balance sheet from funding decisions.

In its place, GASB wants employers to use the NPL on the balance sheet. This number is similar to the unfunded pension obligation, a figure already required to be developed and disclosed in the notes accompanying employers' financial statements. You might be tempted to say "So what?" Why does it make a difference where this number is displayed? Here are three reasons:

1. <u>The NPL is too volatile and would make it virtually impossible to use the balance sheet to hold plan sponsors accountable for their funding decisions regarding pensions</u>. The NPL is to be calculated by subtracting the market value of the plan's assets from total pension liabilities. Currently, the number that is calculated and shown in the financial statement's notes (aka the "Unfunded Actuarial Accrued Liability" or UAAL) uses a smoothed value of assets. The difference this can make is substantial, both in terms of the overall amount that results, as well as in its volatility. The following chart clearly shows how much higher, and more erratic, this NPL number would be compared to the UAAL that would continue to be used for funding.

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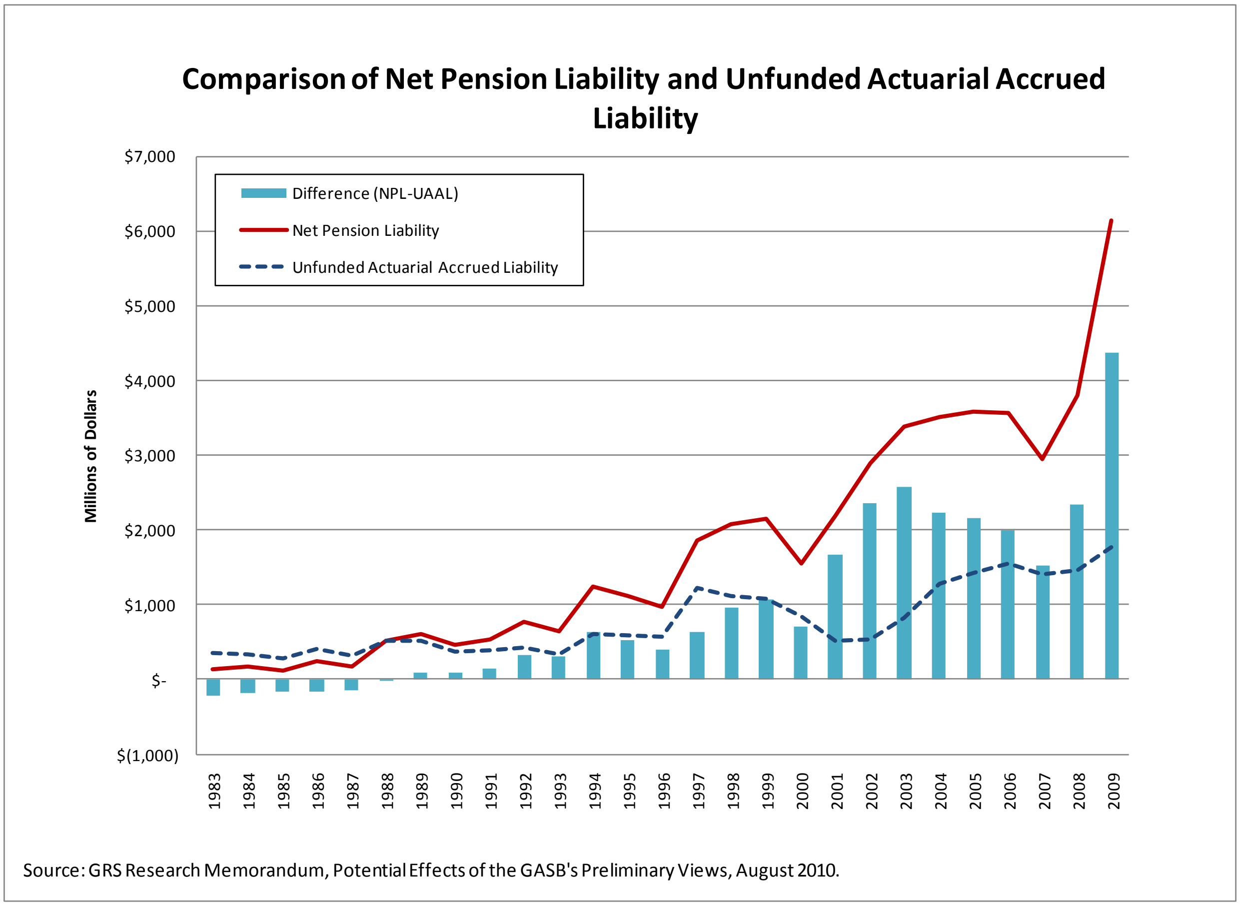
[1] Center for Retirement Research, "The Financial Crisis and State/Local Defined Benefit Plans" November 2008
[2] GASB White Paper, "Why Governmental Accounting and Financial Reporting Is—And Should Be—Different" March 2006



An August 2010 Gabriel, Roeder, Smith & Company study applied several of the GASB PV's key changes to a modeled public pension plan, based on a medium-sized statewide plan covering general employees. The GASB's changes are applied as if they were applicable starting in 1983, and the resulting accounting measures are estimated based on the plan's historical experience through 2009.

As is clear, the NPL that would be placed on the employer's balance sheet (the red line) is much more volatile than the number that would be used to determine funding and displayed in the notes (the UAAL, shown as the dotted blue line). Furthermore, these two numbers would have diverged sharply in 2000 for the modeled plan, when the value of equity investments fell and unfunded liabilities increased. This is because the NPL does not permit the smoothing of investment gains and losses, as does the funding number. As a result, between the years 2000 and 2009, the NPL would have been at least double or triple the amount of the UAAL. Also, as the chart shows, in 2008, when the second financial downturn of the decade caused asset values to drop even further, it produced an unprecedented increase in the NPL in 2009 (almost four times the UAAL number).

This extreme volatility and disconnect between the measure of liabilities used for funding purposes and those shown on the balance sheet will create confusion among the public and other users of the financial statements. Which number is the "real" number? If the NPL is four times larger than the UAAL, then why isn't the plan sponsor making four times the contribution that is based on the UAAL instead? Clearly, the NPL will not improve budget accountability related to pensions; it will destroy it.

2. <u>The NPL will create budgetary chaos that in turn will encourage short-term solutions with long-term negative consequences for future generations</u>. The NPL often will dwarf other, non-pension liabilities on the balance sheet. This will result in a lack of materiality, and will therefore undermine the decision-usefulness of the employer's financial statements.

Tables A and B, below, show liabilities, before and after inclusion of the NPL, for Idaho and Missouri. Their state retirement systems are mid-sized with funding conditions that are within a normal range for public pension plans. The tables depict the change in state liabilities from FY 08 to FY 09, before and after adding the NPL to the state liability figure. These tables also identify the portion of total liabilities accounted for by the NPL.

For Idaho, adding the NPL increases the year-over-year change in the state's total liabilities ***from less than one percent to more than 44 percent***. Also, in FY 08, the NPL accounts for around 14 percent of all of Idaho's pension liabilities, increasing to over 40 percent in FY 09.

Table A. Comparison of changes in the State of Idaho's liabilities with net pension liability not included and included ($ in thousands)

	6/30/08	6/30/09	% change
Liabilities per current standards, with no pension liability included	$1,181,649	$1,190,915	0.8%
Liabilities per proposed standards, *with NPL included*	*$1,380,107*	*$1,992,964*	*44.4%*
NPL as a percentage of total liabilities	14.4%	40.2%	

For Missouri, including the NPL increases the year-over-year change in total liabilities ***from around 15 percent to more than 65 percent***. Also, the NPL accounted for around 60 percent of Missouri's total liabilities in FY 08, increasing to more than 70 percent in FY 09.

Table B. Comparison of changes in the State of Missouri's liabilities with net pension liability not included and included ($ in thousands)

	6/30/08	6/30/09	% change
Liabilities per current standards, with no pension liability included	$ 1,881,827	$ 2,169,194	15.3%
Liabilities per proposed standards, *with NPL included*	*$4,654,558*	*$7,696,362*	*65.4%*
NPL as a percentage of total liabilities	59.6%	71.8%	

The experience of these two states is fairly representative of the experience other states would have under the PV proposal. When the NPL accounts for such a large portion of an employer's liabilities, and when the liabilities can change so much from one year to the next, a relatively small change in the NPL can exert a major and disproportionate effect on the state's overall liabilities, an outcome that will render the basic financial statements virtually useless when it comes to trying to make difficult decisions regarding future spending for all an employer's responsibilities, not just pensions.

Furthermore, what happens if negative annual pension costs are reported? It is entirely possible that an overfunded pension plan could cause the employer's liabilities to also become negative, i.e., to be in net surplus. What conclusions would users of financial statements draw from this situation? That the employer had no net liabilities, and indeed, has a surplus? However, these pension assets are, by both Federal and state laws, to be used solely for the exclusive benefit of plan participants, and cannot be used as general revenues for other purposes. Such a condition therefore could easily lead users to misunderstand the meaning of the balance sheet, and place pressure on decision-makers to make dangerous spending choices that could threaten any interperiod equity that GASB believes its new changes will enhance.

Even if, in response, the defined benefit pension (DB) system was closed, the NPL number would continue to be required on the balance sheet for years to come as the plan slowly died. It could actually become a higher number since the closed DB plan, starved of future employees' contributions, would likely see its assets fall and its liabilities increase.

3. <u>The NPL is not sufficiently reliable and would diminish the usefulness of the balance sheet for decision-making purposes</u>. The NPL is based on assumptions about future events that can always change, such as the amount of salaries that will be earned in the years ahead, the ages at which employees will retire (and eventually pass away), and other so-called "actuarial" assumptions. A plan's actual investment earnings may also vary from projections. In addition, the pension structure itself may change.

These changes are often not minor adjustments; they can create major shifts. For example, recent changes in Colorado produced a reduction in unfunded pension liabilities of $8.8 billion, ***equal to more than one-third of the combined unfunded liabilities***. In Minnesota, modifications approved this year resulted in a change of ***more than $2 billion***, demonstrating that while pension obligations may be unavoidable, they are often not measurable with sufficient reliability to warrant their inclusion on an employer's balance sheet. Finally, changes in South Dakota have made a ***nearly 60 percent difference*** in liabilities.

Accordingly, even if the NPL does meet the conceptual definition of a liability, it is doubtful whether any estimate of it is or can be sufficiently reliable to qualify for recognition on an employer's balance sheet. It would therefore severely diminish, not improve, the usefulness of the employer's balance sheet for decision-making purposes.

In summary, the employer's unfunded pension obligation should continue to be subject to disclosure in notes to financial statements, as required in GASB's current Statements 25 and 27 governing pension accounting and disclosure, not recognized on the employer's balance sheet.