Guam Professional Development Conference

"Trends, Tools, and Techniques in Today's Financial Environment"

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Hotel Nikko Guam

GASB 67 & 68 – Accounting and Auditing Implementation Issues

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Implementing GASB's New Pension Standards

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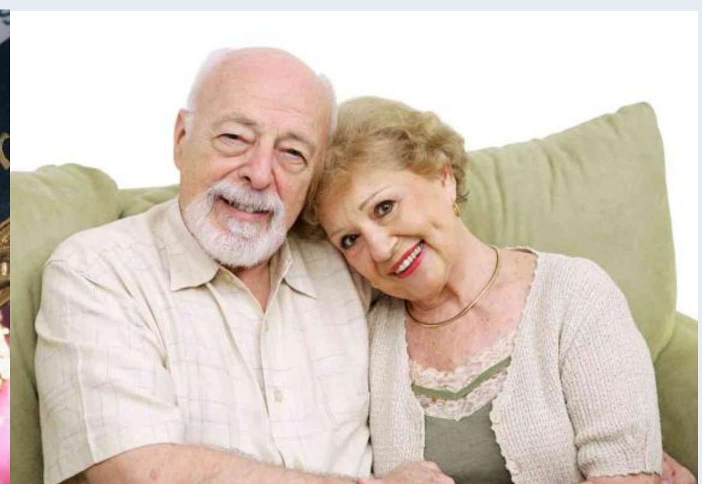

GASB 67 and 68 Represent Huge Changes

- New standards approved June 25, 2012
  - Statement 67 replaces Statement 25 for Plan reporting
  - Statement 68 replaces Statement 27 for Employer reporting
- Major Game Changers in the new rules

❶ Placing the Net Pension Liability on the Balance Sheet

❷ Decoupling Expense from Funding

❸ Accounting for Cost-Sharing Plans

❹ Expanding Disclosure Information (Notes & RSI)

- Timing and Frequency, Effective Dates

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Key Elements of 67 and 68

- Effective dates For plan reporting: Effective for all plans for plan years beginning after June 15, 2013 (2013/2014 for fiscal year plans or 2014 for calendar year)
  - For employer reporting: Effective for fiscal years beginning after June 15, 2014 (2014/2015)
- GASB "Implementation Guide" will be essential –
  - Plans 2013
  - Employers 2014
- OPEB coming in 2014-2015 with similar provisions

GASB Objectives and Goals

Financial Reporting Focus

- GASB establishes accounting and financial reporting, not funding policies
- Focus on pension obligation, changes in obligation, and attribution of expense
- All determined consistent with GASB's "Concept Statements"

Long-Term Nature of Governments

- Cost of services to long-term operation
- "Interperiod equity" matches current period resources and costs

Employer-Employee Exchange

- Employer incurs an obligation to its employees for pension benefits
- Transaction is in context of a career-long relationship

Big Deal #1 (the big one for auditors): Net Pension Liability Reported on Balance Sheet

- Net Pension Liability (NPL)
  - Total pension liability minus plan assets at market value ("plan net position" as of June 16, 2012 due to GASB-63)
  - Similar to Unfunded Actuarial Accrued Liability (UAAL) but using market assets, not "smoothed" assets
- NPL must be reported on the employer's balance sheet
  - Currently, UAAL is reported in the Required Supplementary Information (RSI)
  - Currently, only the Net Pension Obligation is reported on the balance sheet
    - Cumulative difference between annual required contribution (ARC) and actual contributions

Net Pension Liability Reported on Balance Sheet

- Total Pension Liability is an Actuarial Accrued Liability, calculated using:
  - Projected future benefits
    - Includes projected future service, salary increases and automatic Cost-of-Living Adjustments (COLAs)
    - Includes the cost of ad hoc COLAs if substantially automatic
  - A new “blended” discount rate
  - “Entry age” actuarial cost method
- NPL is then TPL minus market value of assets
  - Note asset smoothing still allowed (in determining pension expense), but reported separately
    - In Schedule of Deferred Inflows and Outflows of Resources

The New “Blended” Discount Rate

- Discount rate is based on projected benefits, current assets, and projected assets for current members
  - Projected assets **include future contributions** that fund benefits for current members
  - Projected assets do **not** include employer or employee contributions that fund service cost for future employees
  - For projected benefits that are covered by projected assets
    - Discount using long-term expected rate of return on assets
  - For projected benefits that are **not** covered by projected assets (i.e., after the “cross-over date”)
    - Discount using yield on 20-year AA/Aa tax-exempt municipal bond index
  - Solve for a single rate that gives the same total present value
    - Use that single equivalent rate to calculate the total pension liability (TPL)

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The New “Blended” Discount Rate

- What future contributions are included when determining the discount rate?
  - Depends upon how employer contributions are determined
  - Are contributions subject to one of the following?
    - A statutory or contractual requirement, or
    - A <u>formal, written policy related to contributions</u>
  - If so, then use professional judgment to project contributions
    - Consider the employer’s 5-year history as indicator for future contributions
  - If neither is true, projected contributions are based on average of contributions for past 5 years

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Long-term Rate of Return Disclosures

- New note disclosures on the long-term rate of return
  - Description of how it was determined
  - Significant methods and assumptions used
  - Expected asset allocation
  - Real rates of return for each major asset class
  - Whether rates of return are arithmetic or geometric means
- Disclosures required regardless of whether or not they were actually used as direct inputs to determine the long-term rate of return

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Big Deal #2 (the big one for actuaries): Decoupling Expense from Funding

- Currently, pension expense is based explicitly on an actuarially determined funding requirement
  - The ARC, which is the "annual required contribution"
    - Even though is not required to be contributed!
  - Based on established practices for managing contribution volatility
    - Asset smoothing and UAAL amortization
  - The ARC served as a de facto funding standard
- New GASB pension expense is the change in NPL each year, with deferred recognition of only certain elements
  - Specifically **not** intended to be a funding target or standard

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Big Deal #2 - Decoupling Pension Expense from Funding

- **Bulletin**
  - Several organizations (NASRA, GFOA, AGA, NASACT, NLC, NCSL) are working on a white paper on pensions
    - Calling for best practice in <u>continuing to provide an ARC</u>
    - Funding in accordance with the ARC
    - Optimum ratio of plan net position to total pension liability

New Pension Expense Components

- Changes in Total Pension Liability that are recognized (i.e., expensed) immediately - no deferrals allowed
  - Service cost
  - Annual interest on the TPL
  - Projected investment returns over the year
  - All plan amendments
- Immediate recognition of all plan amendments, whether for all actives or retirees

New Pension Expense Components

- Changes in Total Pension Liability where some deferrals are allowed (i.e., expensed over multiple periods)
  - Changes in actuarial assumptions
  - Actuarial gains and losses
- These changes in TPL are recognized in expense over average expected remaining service lives of active and inactive members (including retirees)
  - Changed from Exposure Draft, where active and retired TPL changes were amortized separately
    - Simpler calculation than was in the ED, but similar impact on expense
    - Resulting amortization periods will still be very short

New Pension Expense Components

- Changes in Assets where some deferrals are allowed (i.e., expensed over multiple periods)
  - Differences between actual and projected earnings over the year (i.e., investment gain/loss)
    - Recognized in expense over closed 5-year period
    - Similar to current five-year asset smoothing
  - So the NPL on balance sheet will be "market volatile", but effect on expense and on employer net position will still reflect smoothing
    - Through "Deferred Inflows and Outflows"
  - Effect on expense will be different from funding (and current ARC), where investment gain/loss is:
    - Smoothed over (typically) five years <u>and</u>
    - Also amortized as part of the UAAL

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Big Deal #2 Decoupling Expense from Funding

- The faster — often immediate — recognition of net pension liability changes will introduce much greater volatility in the reported pension expense.
  - This volatility will be reflected directly on the income statements of plan sponsors.
- This volatility is what disqualifies this new expense as a basis for determining a funding policy.
  - Means there will be two competing measures of plan cost
- Plans will want to review or adopt funding policies, now that GASB expense no longer provides funding guidance.
  - Funding policy also needed for discount rate – and for disclosures.

Big Deal #3 (the big one for statewide systems): Proportionate reporting for Cost-Sharing Plans

- Current standards have very simple reporting:
  - Pension expense is contractually required contribution
  - Balance sheet liability is the accumulated difference between the contractually required contribution and the actual contribution
  - No ARC or NPO (except as above)
  - Unfunded actuarial accrued liability is not reported at all
- New standards – treated like single employer plans:
  - Employers in "pooled" plans will now have that "pooled" liability and expense apportioned to each employer.
  - Recognize "proportionate share" of collective net pension liability, pension expense, and deferred inflows and outflows

Cost-Sharing Plans

- Determining an employer's "proportionate share"
  - Basis should be consistent with the way required contributions are determined
  - "The use of the projected long-term contribution effort of the employer(s) … is encouraged."
  - If "different contribution rates are assessed based on separate relationships that constitute the net pension liability … the determination of the employer's net pension liability should … reflect those separate relationships."
    - "For example, separate rates are calculated based on an internal allocation of liabilities and assets for different classes or tiers of employees"

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Cost-Sharing Plans

- Measurement date
  - A cost sharing plan can determine its NPL (total pension liability and market assets) at one date each year
    - Probably the plan's valuation date
    - Each employer's share can be as of that same date
    - This is a welcome improvement over the ED
  - Still a substantial new burden for cost-sharing plans.

Special Funding Situations

- A state or government that is not the employer contributes to the plan may be assuming a portion of the NPL
  - Example – Law governing a teacher retirement system requires the State to contribute 50% of the school district contributions on their behalf
- These "Nonemployer Contributing Entities" do not have to report a portion of the NPL on their balance sheets if:
  - The entity has no legal obligation to contribute or
  - The entity's contribution requirement is defined in terms of a dedicated revenue stream
- Otherwise these entities must disclose their proportionate share of the collective NPL

Expansion of Disclosure Information

- Includes both Notes and Required Supplementary Information (RSI)
- *Greatly* expanded plan and employer disclosures, including:
  - Description of the plan and assumptions
  - Policy for determining contributions
  - Sensitivity analysis of the impact on NPL of a one percentage point increase and decrease in the discount rate
  - Changes in the NPL for the past 10 years
  - Development of long-term earnings assumption
  - Annual rates of investment return for past 10 years (plan only)

Expansion of Disclosure Information

- More new disclosure information
  - "Actuarially determined employer contribution"
    - ADC is the "New ARC"
    - Basis and amount – if determined!
    - Comparison to amount actually contributed
    - May encourage review (or creation) of actuarial funding policy
- Expanded disclosures greatly increase the pension information needed for plan and employer's financial statements.
  - New and challenging questions for <u>employer's</u> financials:
    - Which actuary develops this information?
    - Who pays for it?

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Comparison of Disclosure - Plans

	Single Employer Plan	Agent Multiple Employer	Cost Sharing Multiple Employer
Plan Description (Name, number of participating & nonparticipating employers, board description & composition, classes of members, authority for changes, contribution requirements)	Yes	Yes	Yes

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Comparison of Disclosure - Plans

	Single Employer Plan	Agent Multiple Employer	Cost Sharing Multiple Employer
Plan Investments (Investment policies, description of fair valuing process, concentrations [>5% of plan position exc. US Governments], Annual Money-Weighted Rate of Return	Yes	Yes	Yes
Receivables	Yes	Yes	Yes

Comparison of Disclosure - Plans

	Single Employer Plan	Agent Multiple Employer	Cost Sharing Multiple Employer
Allocated Insurance Contracts	Yes	Yes	Yes
Reserves (descriptions, policy)	Yes	Yes	Yes
Deferred Retirement Option Plan (terms and balances)	Yes	Yes	Yes

Comparison of Disclosure - Plans

	Single Employer Plan	Agent Multiple Employer	Cost Sharing Multiple Employer
Components of Liability of Employers and Non-Employers (TPL, plan net position, NPL, Fiduciary net position)	Yes	NO	Yes
Significant Assumptions (COLAs, discount rate etc.)	Yes	NO	Yes
Actuarial valuation information	Yes	NO	Yes

Comparison of RSI - Plans

	Single Employer Plan	Agent Multiple Employer	Cost Sharing Multiple Employer
10 year change schedule of NPL	Yes	NO	Yes
10 year TPL, NPL, Covered Payroll	Yes	NO	Yes
IF ADC is determined, 10 year schedule comparing contributions to ADC	Yes	NO	Yes
Money Weighted Rate of Return	NO	Yes	NO

Updated Disclosure – EMPLOYERS

	Single Employer (example - Fire system)	Member of Agent Plan	Member of Cost Sharing Plan
Pension accounting elements (liabilities, assets, deferreds etc.)	Yes – component units reported separately	Yes – same as single employer	Yes – proportionate amounts
Pension Plan descriptive elements / sensitivity analysis	Yes – using "real rate of return"	Yes	Yes
Assumptions	Yes	Yes	Yes – how proportion is determined
Discount rate	Yes	Yes	Yes

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Updated Disclosure – EMPLOYERS

	Single Employer (example - Fire system)	Member of Agent Plan	Member of Cost Sharing Plan
Plan's fiduciary net position	Yes	Yes	Yes
Changes in NPL	Yes	Yes	NO
Valuation information	Yes	Yes	NO
If Special Funding Situation – proportion info – other items	Yes	Yes	Yes

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RSI –EMPLOYERS

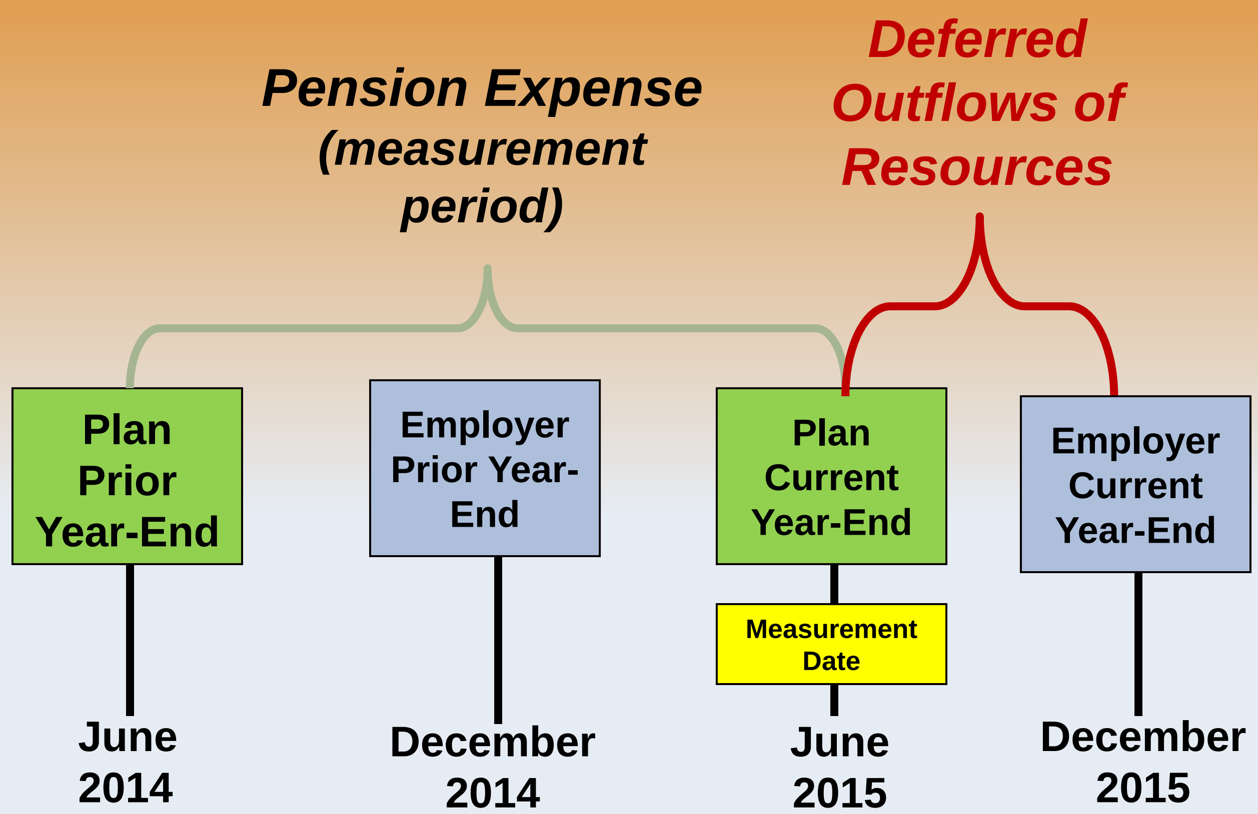
	Single Employer (example - Fire system)	Member of Agent Plan	Member of Cost Sharing Plan
10 year schedule of NPL changes	Yes	Yes	NO
10 year schedule of pension liability, NPL, covered payroll etc.	Yes	Yes	If NO SFS then YES. IF SFS, then proportionate amount only
If ADC is done, comparison as of employer's FYE	Yes	Yes	NO
If NO ADC – contributions required and made	Yes	Yes	Yes

Timing and Frequency of Measurement of Total Pension Liability

- Employers should report in their financial statements a *net pension liability (asset)* determined as of *a date (measurement date) no earlier than the end of the employer's prior fiscal year* for each defined-benefit pension plan in which they participate
- ***The measurement date used should be consistently applied from period to period***
- Measurement of the total pension liability is determined through:
  - An actuarial valuation performed as of the *measurement date,* or
  - The use of update procedures to roll forward amounts from an actuarial valuation as of a date no more than *30 months and 1 day* earlier than the employer's year-end
  - Use professional judgment in determining extent of update procedures when changes in plan occur between last valuation date and the ***measurement date***

Measurement date will most likely correspond to year-end of plan. In this case, employers with same year-end as plan must choose measurement date as of their prior or current year-end.

Timing of Measurement of Total Pension Liability



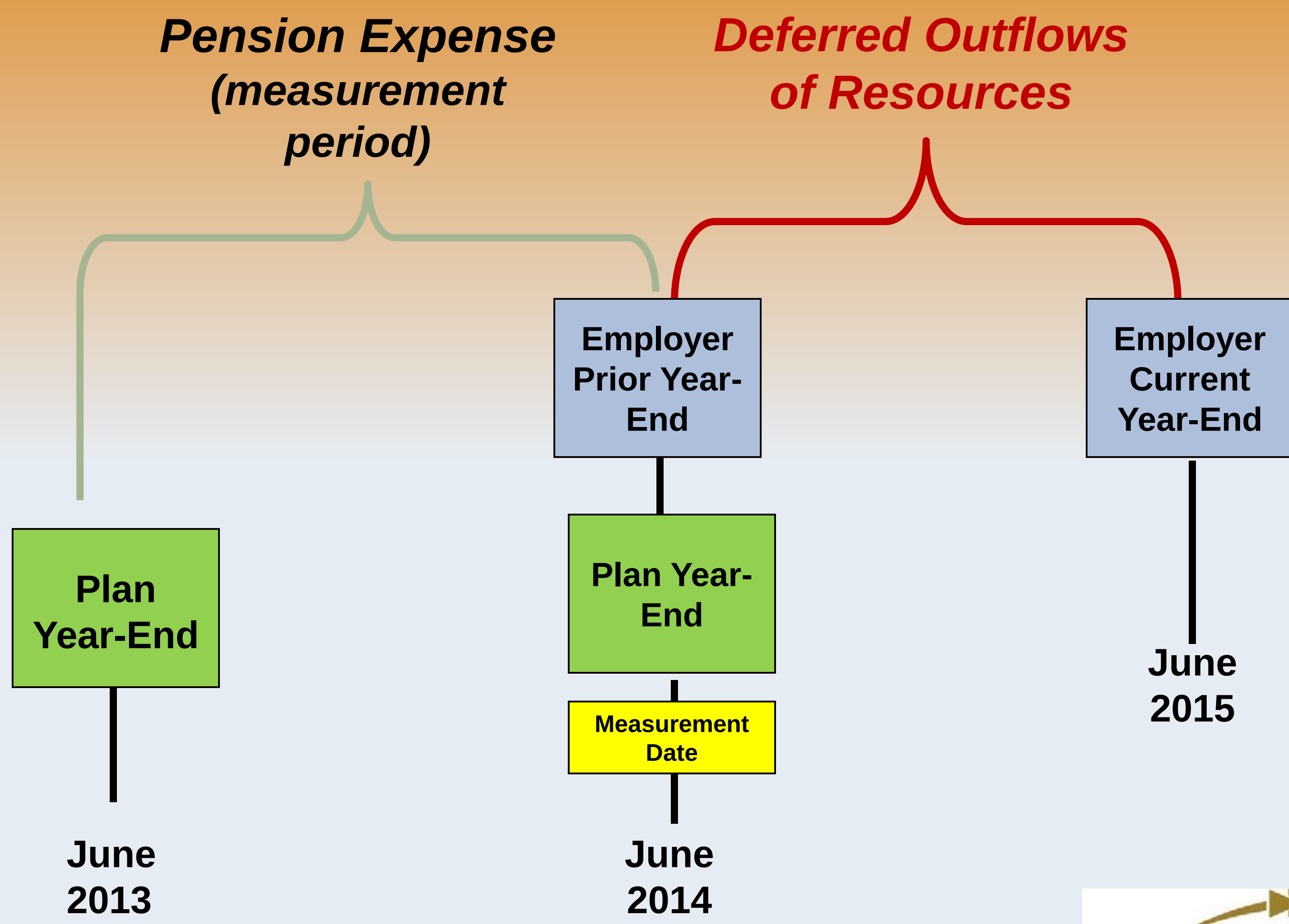
Measurement date will most likely correspond to year-end of plan. Employer contributions made directly by the employer subsequent to the measurement date of the net pension liability and before the end of the employer's fiscal year should be recognized as a deferred outflow of resources.

Example Sample City

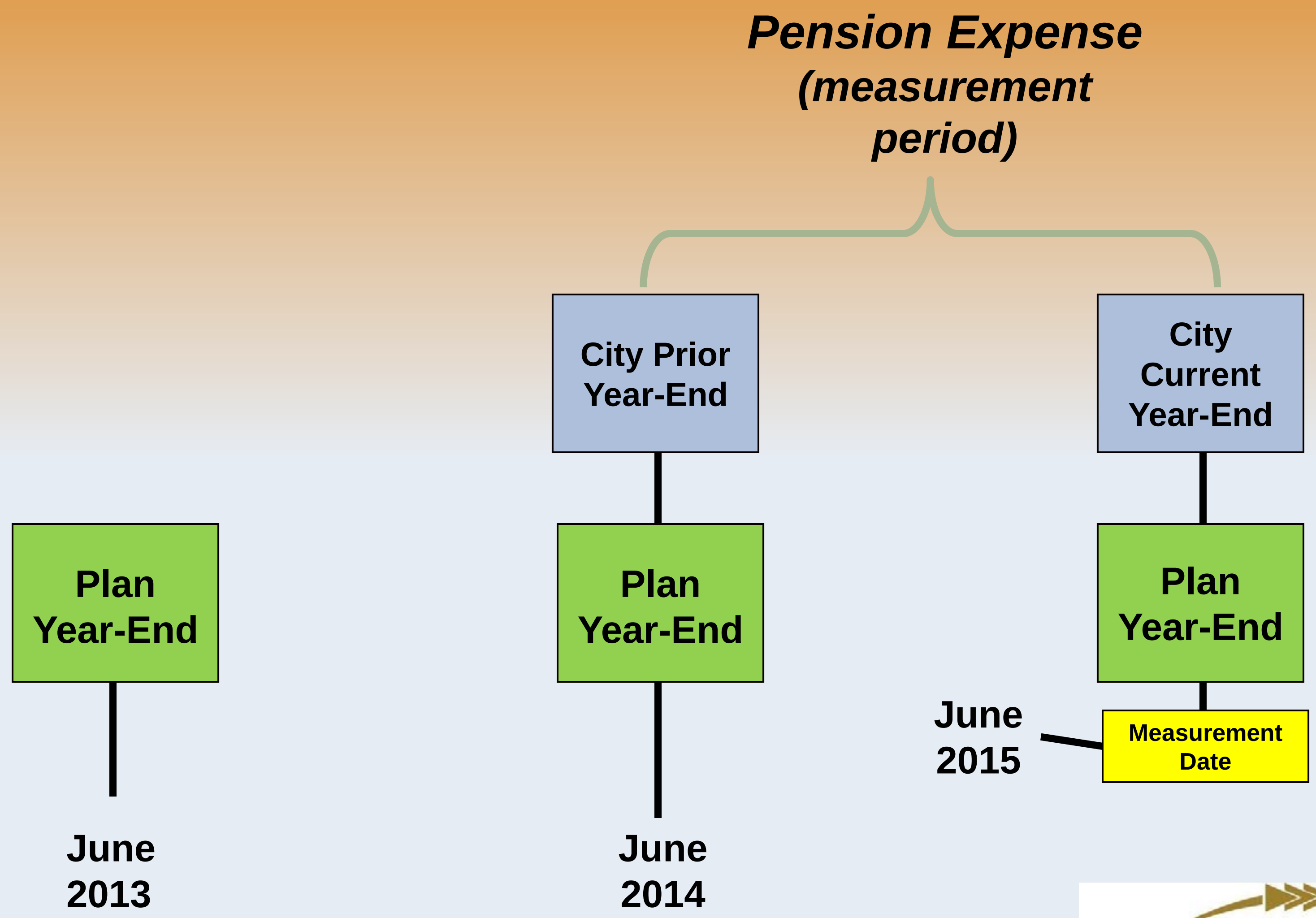
Sample City participates in a cost-sharing multiple-employer defined-benefit plan sponsored by the State of Example. Sample City is implementing GASB Statement 68 during the year ended June 30, 2015. The cost-sharing plan also has a fiscal year-end of June 30th and implemented the provisions of GASB Statement 67 during the year ended June 30, 2014. Sample City's financial statements are a single-year presentation.

In accordance with GASB Statement 68, the measurement date for Sample City must be as of a date no earlier than the end of its prior fiscal year. Since Sample City and the Plan have the same year end, Sample City may elect to use June 30, 2014 or June 30, 2015 as the measurement date. However, once selected, the measurement date should be consistently applied from period to period.

Example Sample City – Impact of Using Prior Year Measurement Date



Example Sample City – Impact of Using Current Year Measurement Date



Recognition of Changes in the Net Pension Liability (NPL) –
NPL = TPL - Assets

Change in the NPL	Expense	Deferred Outflow or Inflow of Resources
Service cost	X	
Interest on TPL	X	
Plan changes	X	
TPL-related differences between expected and actual experience (e.g. change in expectancy, other actuarial changes beyond assumptions)	Single-period piece	Both active & inactive portion (with piece expensed) amortized over average expected remaining service life of active & inactive using closed end periods
TPL-related changes in assumptions	Single-period piece	Both active & inactive portion (with piece expensed) Same

Recognition of Changes in the NPL
(cont.)

Change in the NPL	Expense	Deferred Outflow or Inflow of Resources
Projected earnings on investments	X (reduction)	
Difference between projected and actual investment earnings	Single-period piece	X (with piece expensed over five years – closed period) Present on a net basis on the statement of plan net position / statement of net position
Other sources	X	

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Illustration: NPL Components/Ratios Required

	20X9	20X8	20X7	20X6	20X5
Total pension liability	$ 3,182,228	$ 3,045,893	$ 2,888,832	$ 2,643,090	$ 2,443,871
Plan net position	(2,512,987)	(2,283,333)	(2,167,168)	(2,152,638)	(1,971,007)
Net pension liability	$ 669,241	$ 762,560	$ 721,664	$ 490,452	$ 472,864
Ratio of plan net position to total pension liability	78.97%	74.96%	75.02%	81.44%	80.65%
Covered-employee payroll	$ 435,373	$ 432,256	$ 426,939	$ 412,280	$ 387,055
Net pension liability as a percentage of covered-employee payroll	153.72%	176.41%	169.03%	118.96%	122.17%

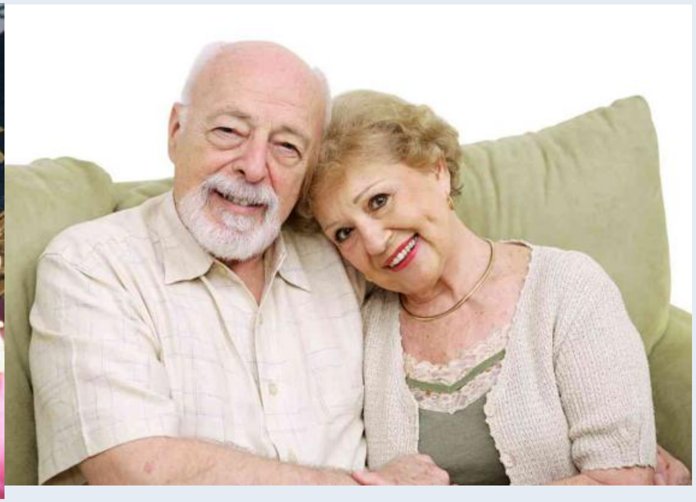
Note: Only 5 years are presented here; 10 years of information would be required

Illustration: Contribution-related Information Required if ADC done

	20X9	20X8	20X7	20X6	20X5
Actuarially calculated employer contribution	$ 109,544	$ 107,028	$ 105,755	$ 103,089	$ 89,054
Actual employer contributions	(109,544)	(107,028)	(105,755)	(103,089)	(89,054)
Annual contribution deficiency (excess)	$ -	$ -	$ -	$ -	$ -
Covered-employee payroll	$ 435,373	$ 432,256	$ 426,939	$ 412,280	$ 387,055
Actual contributions as a percentage of covered-employee payroll	25.16%	24.76%	24.77%	25.00%	23.01%

Note: Only 5 years are presented here;
10 years of information would be required

Best Practices in Implementation



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Best Practices in Implementation

- Key Worries to be Addressed as part of Implementation per GASB Letter to the Profession
  - Pension funding policy
  - Selection of assumptions
  - Timing of measurements
  - Timing of actuarial valuations
  - Development of information for employer reporting

Best Practices in Implementation

- Funding Policy
  - Statements remove the direct link between measurements for funding purposes and measurement of pension expense for accounting and financial reporting purposes. For governments that have actuarially based funding policies, the measurement requirements of the new Statements for financial reporting purposes will include an actuarial valuation likely different from (and in addition to) the actuarial valuation that is used for funding purposes.
  - **Address through Consistent Communication**

Best Practices in Implementation

- Selection of Assumptions
  - Coordination will be necessary between pension plans and employers when measurements of the net pension liability of the employers are made. Assumptions integral to the measurement of an employer's pension liability include the long-term expected rate of return on pension plan investments, which plays a potentially significant role in the determination of the discount rate.
  - **Address through Communication, alignment of all actuarial assumptions to expectations of employers**

Best Practices in Implementation

- Timing of Measurements
  - Issue will be requirement to present information about the liabilities of the employers, the net pension liability is required to be measured as of the end of Plan's fiscal year.
  - Employers are provided with additional flexibility with regard to the "as of" (or "measurement") date of the net pension liability reported in its financial statements each period.
    - Employer may report a pension liability measured between the end of the employer's prior fiscal year and its current fiscal year-end (for example, as of the pension plan's fiscal year-end). Because information about pension plan net position is needed to measure the employer's net pension liability, in pension plans in which the same fiscal year-end is not shared among the employers and the plan itself, coordination of the employers' measurement date will be necessary.
  - **Address through coordination and timely transmittal of information to members**

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Best Practices in Implementation

- Timing of Actuarial Valuations
  - Should not be an issue with as long as annual valuations are performed
    - If Plan and employer fiscal year-ends are different, attention to the timing of the actuarial valuation date relative to those fiscal year-ends will be necessary to ensure that the actuarial valuation date, in conjunction with the measurement date (discussed above), will fall within the timing requirements of the new Statements.
    - Again – shouldn't be a problem

Best Practices in Implementation

- Development of Information for Employer Reporting
  - **Key concern for Plans**
    - RSI schedule information (up to 10 years prior)
    - Additional information on cost sharing employer information expense
  - Key Questions
    - Who prepares it?
    - When is it released?
    - **Is it auditable?**

Best Practices in Implementation

- Development of Information for Employer Reporting
  - Questions *may* be answered by some / all of the following:
    - Implementation Guide(s)
    - AICPA Update to State & Local Audit Guide (new pensions chapter coming **but not until 2014)**
    - Task force coordination at each plan
  - But – who pays for it?

Best Practices in Implementation

- Key additional question for
  - Information to determine employers' proportionate shares needs to be tested and agreed upon
    - Net pension liability and other elements are dependent on it
    - Standard encourages that each employer's projected long-term relative share of contributions to the plan as the basis for establishing each employer's proportion
  - **Address through dry runs, communication**

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Auditing Provisions *May* Be

- Cost sharing schedule for all employers may be required by AICPA even though not in GASB-67
  - Schedule includes all elements for all employers
  - Key risks audited including census data, benefit payments, posting of investment return to accounts etc.
  - Full guidance not until 2014

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Best Practices of Implementation

- Some Plans are using a task force
  - Plan administration / controller
  - Plan auditor
  - Plan actuary
  - Employers' controller staff
  - Employers' auditor(s)
- Goals
  - Communication and documentation of decisions (see above)
  - Understanding of timeline
    - Roles & responsibilities
  - Uniformity in presentation

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Questions

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