San Bernardino County Employees' Retirement Association

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GASB 67 & 68 (COLA)
Frequently Asked Questions (FAQ)

1. When do these new standards go into effect?

Statement No. 67 replaces the requirements of the existing Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and is effective for SBCERA beginning in fiscal years ending June 30, 2014. SBCERA included these new requirements in its *Comprehensive Annual Financial Report* for the year ended June 30, 2014.

Statement No. 68 replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*. This reporting requirement applies to the GAAP-based financial statements of employers and is effective for fiscal years beginning after June 15, 2014.

2. What do these new standards mean for employers?

Each employer is part of a single pension trust fund at SBCERA. GASB now will require, for purposes of governmental financial reporting, that a proportionate share of the total net pension liability (unfunded liability) of the SBCERA pension trust fund to be shown on the face of each employer's financial statements. Similarly, a proportionate share of the total pension expense and collective deferred outflows of resources and deferred inflows of resources of the SBCERA pension trust fund will also be shown on the face of each employer's financial statements. In addition, these standards will require employers to include additional footnote disclosures about the pension trust fund in their financial statements.

3. Will the new pension standards affect an employer's bond ratings?

SBCERA cannot speak for rating agencies. As a general practice, rating agencies do incorporate liabilities into their analysis of a government's ability to meet its debt obligations. Employers should contact their rating agency directly for more information. See the Bond Rating Links on the Links page for more information from Moody's, Standard and Poor's and Fitch Ratings.

Separating Accounting and Funding for Pensions

4. **Do the new pension standards increase employers' contribution rates paid to SBCERA?**

   No. The new standards do not establish requirements for how pensions are funded. Determining required contributions are a funding issue, not an accounting issue, and the new standards relate only to how employers account for and report pension costs (accounting and financial reporting requirements). Required contributions are determined by the SBCERA Board of Retirement in consultation with SBCERA's independent, professional actuary.

5. **Why are pension funding principles no longer compatible with accounting?**

   The liability that was reported in financial statements for pension obligations previously was based on shortfalls between a government's contribution targets (the annual required contribution) and the contributions it actually made. However, this measure of an obligation does not fully represent the pension liability. Likewise, annual contribution targets do not always fully represent pension expense for the reporting period.

   Moreover, the GASB concluded that it is not within the scope of its activities to set standards that appear to establish a specific method of funding pensions or to regulate a government's compliance with its financing policy or requirements.

6. **What are the benefits of an accounting-based approach for reporting pension activities?**

   One of the primary benefits of an accounting-based approach is that it reports (1) a liability for the amount of pension benefits that have yet to be financed as of a specific point in time and (2) the pension expense that was incurred during the reporting period. The use of an accounting-based approach also enhances comparability between governments because all governments use the same measurement methods. A funding-based approach generally cannot produce comparable measures of the pension liability and pension expense because the methods used to determine how much to contribute to a pension plan each year may differ substantially from plan to plan.

Annual Required Contributions (ARC)

7. **Why not continue to require governments to provide information on the ARC?**

   The GASB determined that the ARC does not always appropriately reflect the pension expense for the reporting period. The ARC-based approach also gave some financial statement users the impression that the measures of the ARC were comparable across governments. However, because there was a range of methods that were acceptable for purposes of calculating an ARC, this was not the case. For these and other reasons, the new pension accounting is not based on the ARC.

Two Sets of Numbers

8. Why are two sets of numbers needed?

The numbers are intended to tell the story of pension-related activities from two different perspectives. The accounting numbers primarily relate to the determination of pension expense for the reporting period and the pension obligation that was incurred as of a point in time. The funding numbers address how pension obligations are funded each year.

9. Which set of numbers are more important?

Both sets of numbers play an important role in government finance. Neither the accounting numbers nor the funding numbers should be ignored.

10. What are the accounting numbers intended to convey?

The accounting numbers convey the amount of deferred compensation (pension benefits) that will be paid to employees after retirement. The amounts reported as liabilities represent the benefits that employees have earned and, therefore, that the government has a present obligation to pay in the future. When the total pension liability exceeds the pension plan's net position (formerly referred to as plan net assets) available for paying benefits, there is a net pension liability. Governments will now be required to report that amount as a liability in their financial statements.

Reporting the net pension liability alongside other liabilities, such as outstanding bonds, claims and judgments, and long-term leases, is a major step toward getting all significant resources and obligations into the financial statements and more completely depicting a government's financial status. The accounting numbers also more closely link the reporting of pension expense with the periods during which pension benefits will actually be earned—as employees work for the government.

11. What are the funding numbers intended to convey?

When the funding numbers are based on an actuarial valuation, the intent is to determine the amount of annual contributions to the pension plan that are needed to fund future benefit payments. These annual contribution targets also will appear in the financial report as 10-year trend information, which allows the government to demonstrate its degree of compliance with its funding policy or statute. The funding numbers also are intended to provide information to assess the funded status of the pension plan.

Pension Liability

12. Where did the pension liability come from?

An accounting liability is an obligation for a government to make a payment (or to give up resources in some manner) in the future. Governments have pension liabilities because they are required to provide pension benefits to their employees in the future when those employees retire. That requirement is a part of employee compensation (in addition to a salary and benefits) and constitutes an obligation that will be reported as a liability under the new accounting standards. In most cases, the obligation to provide pension benefits has existed for decades, predating not only the new accounting standards but also the standards they are replacing.

13. How is measurement of pension liabilities changing?

Whereas governments used to report their unfunded actuarial accrued liability (UAAL) for pensions, they now report a new measure—the net pension liability (NPL). Both the UAAL and the NPL represent the portion of a government's obligation for pension benefits that is not covered by assets contributed to and invested by a pension trust fund. The UAAL and the NPL are both calculated by subtracting (1) a measure of the value of those assets in the plan from (2) a measure of the total cost of future pension benefit payments already earned, stated in current dollars. However, the new accounting standards have changed how the value of plan assets and the total cost of pension benefits are measured. As a result, the new pension liability measure (the NPL) might be notably larger or smaller than the old pension liability measure (the UAAL).

14. How will SBCERA determine the Total Pension Liability (TPL)?

First, SBCERA's independent, professional actuary will determine the projected total future pension benefit payments owed for current and retired members. The actuary will consider plan assumptions such as projections for salary increases, and retirement and mortality rates. Next, the projected benefit payments will be discounted to their value at the time of measurement (their present value at a specific date). SBCERA is required to use the long-term expected rate of return on their investments to the extent the rate supports projected benefit payments of the plan. For the period of benefit payments not supported, an index rate for 20-year tax- exempt municipal bonds is used which results in one blended rate of return. Finally, the present value of projected benefit payments will be attributed to the periods when they were or will be earned. This is determined by the actuary using an entry age actuarial cost method, applied as a level percentage of payroll. The portion of the present value of projected benefit payments that is attributed to past periods of employee service is the Total Pension Liability. TPL – Plan Net Position (the value of the assets in the pension trust fund that can be used to make benefit payments) = Cumulative Net Pension Liability (NPL). NPL is then apportioned to each employer to report in their own financial statements.

15. How may other changes in the accounting standards affect the size of the pension liability that is reported?

Changes in how the value of pension assets is measured will affect the size of the reported pension liability. Whether these changes make the NPL larger or smaller compared with the previously reported pension liability (the unfunded actuarial accrued liability or UAAL) will depend on the particular circumstances of the government in question.

- Under the old accounting standards, to calculate the UAAL, the value of pension plan assets was measured as a *smoothed* value of assets. In other words, when the value of the plan's investments increase or decrease each year, the full amount of the change is introduced into the value of assets gradually over a five year period, rather than immediately.

- Under the new accounting standards, smoothing of asset values has been eliminated. Instead, the NPL equals the total pension liability minus the value of the assets in the pension plan that can be used for benefit payments as of the same date as of which the total pension liability is measured.

- The fair value of plan assets may be greater than the smoothed value of assets. As a result, all other things equal, the NPL reported by many governments might be smaller than the UAAL that was reported under the previous standards.

16. How is the proportionate share determined?

A government's proportionate share of the NPL would equal its proportion multiplied by the collective NPL for the pension trust fund as a whole. The new accounting standards encourage that the proportion be calculated as follows: (1) a government's projected long-term contributions to the plan divided by (2) the projected long-term contributions to the plan by all governments (and other entities on behalf of those governments). However, the calculation of a government's individual proportion may be based on other factors that are relevant to how contributions to the plan are determined. For instance, a government's percentage might be determined by dividing (a) the government's contributions in the period prior to the date the NPL is measured by (b) contributions of all participating governments and non-employer entities during that period.

For SBCERA, contribution rates are determined by actuarial cost groups. Each employer belongs to one or more cost groups. The NPL is allocated based on the actual employer contributions within each cost group. The County Safety, South Coast Air Quality Management District and Superior Court actuarial cost groups (cost group) have only one active employer each, so the entire NPL for those cost groups is allocated to those employers. For all other cost groups, the NPL is allocated based on the actual employer contributions within the cost group. The steps used to determine each employer's proportionate share are as follows:

1. The NPL is the TPL minus the Plan's fiduciary net position. The TPL for each cost group is determined by actuarial valuation results calculated by SBCERA's actuary, based on the actual participants in each cost group. The fiduciary net position for each cost group was estimated by adjusting the valuation value of assets for each cost group by the ratio of the total Plan net position to total Plan valuation value of assets.

2. Then calculate the ratio of employer's contributions to the total contributions for the cost group.

3. The ratio is then multiplied by the NPL for the cost group to determine the employer's share of the NPL for the cost group.

4. The NPL associated with SBCERA (as the employer), and any surplus or remaining unfunded liability from the withdrawn employers (after taking into account their fixed payment agreement) have been reallocated to the remaining active employers, based on each employer's NPL prior to the reallocation

    - The total allocated NPL for each employer is the sum of items 3 and 4 above.

The proportionate share percentages are calculated by dividing each employer’s allocated NPL in item 5 by the NPL for the Plan as a whole.

<u>Cost-Sharing Multiple-Employer Pension Plans</u>

17. What is a cost-sharing multiple-employer pension plan?

In a cost-sharing multiple-employer pension plan, the contributions of multiple governments and their employees are combined. The pension benefits of the retirees of all participating governments are paid out of this common pool of assets. SBCERA is a cost-sharing multiple-employer pension plan.

18. **Why do governments in cost-sharing plans have to report their pension liabilities?**

Taxpayer associations, municipal bond analysts, and others who use audited financial reports need information about government pension obligations to make decisions and to assess government accountability. Most notably, users of government financial reports want to know the size of a government's pension liability and the degree to which the liability is covered by assets set aside in a pension plan trust fund. These financial report users need this information regardless of what type of pension plan a government participates in. The new pension standards require all governments to report their net pension liabilities regardless of the type of pension plan they have.

Change in Pension Liability from Year to Year

19. **Why will the new accounting standards potentially result in more significant annual changes in the pension liability than have been reported in the past?**

Governments are now reporting a net pension liability (NPL) in their financial statements, along with other liabilities such as outstanding bonds. The NPL is a measure of the portion of a government's obligation for pension benefits that is not covered by assets contributed to and invested by a pension trust fund. The NPL is calculated by subtracting the value of those assets in the plan from the total pension liability (a measure of the total cost of future pension benefit payments already earned, stated in current dollars). The value of plan assets is determined as of the same date that the total pension liability is measured. In other words, there is no smoothing of asset values, as had been permitted under the old accounting standards. Because these asset values might change significantly from year to year and there is no smoothing, the NPL also might change significantly.

Pension Expense

20. **How was the annual pension expense measured under the prior accounting standards?**

The amount reported as the annual pension expense under the old accounting standards was based on a measure called the annual required contribution (ARC). The ARC had two components. One component, normal or service cost, essentially represented the cost of benefits newly earned by a government's employees during the year. The other component was a portion of the government's unfunded pension liability, the amount of its total pension obligation that was not covered by assets set aside in a pension trust fund. The unfunded liability is recognized into expense over a period of up to 20 years.

21. How do the new accounting standards measure annual pension expense?

Changes in the employer's apportioned Net Pension Liability from one year to the next is considered pension expense as it relates to service cost, interest on the Total Pension Liability and changes in benefit terms. However, there is a provision in the standard which requires certain items to be deferred and allocated over multiple years. Of these, the following are introduced into annual pension expense over the average remaining years of service of all members of the pension plan (both current and former employees):

- Changes in the assumptions when measuring the pension liability, for instance, if an assumption was increased about how long employees live after retirement, the likely result would be an increase in the total pension liability (because retirees are living longer and, therefore, collect pension benefits for a longer period).

- Differences between (1) the assumptions about demographic and economic factors when measuring the pension liability and (2) what those factors actually turned out to be (often called experience gains and losses), for instance, if actual salary increases turned out to be less than assumed when measuring the total pension liability, the effect would be a reduction from what the total pension liability was expected to be.

Increases or decreases in the NPL are introduced into annual pension expense over a five-year period (an approximation of a typical market cycle) for the following:

- Differences between (1) assumption for the income from pension plan investments and (2) the actual investment income, for example, if the actual investment income in a particular year was less than expected, the result would be a lower value of plan assets, and a higher NPL, than was expected.

22. For the exceptions above, how are those changes in the NPL introduced into pension expense over multiple years?

The amounts of increases and decreases in the NPL resulting from those types of events are required to be introduced into pension expense in a "systematic and rational manner." This introduction into pension expense happens as follows:

- One part of the amount of the increase or decrease in the NPL is included in pension expense in the first year.

- The remainder of the increase or decrease in the NPL is reported in a government's statement of net position as a deferred outflow of resources (an increase in the NPL) or a deferred inflow of resources (a decrease in the NPL).

In the next year, another portion of the increase or decrease in the NPL is included in pension expense and the deferral is reduced by the same amount. This continues until the entire amount has been included in pension expense (either the last year of the average remaining years of employee service or the fifth year, as applicable).

23. How do a government's contributions to a pension plan affect pension expense?

Contributions made by a government to the pension plan reduce the NPL. However, they do not affect the annual pension expense reported by the government.

24. What is a deferred outflow of resources or a deferred inflow of resources?

Most inflows of resources and outflows of resources—such as the receipt of property tax payments or the payment of salaries to employees—are reported as revenues or expenses in the year in which they happen. However, certain inflows and outflows of resources that occur in a given year are actually related to future years. Thus, they are reported as deferred inflows of resources or deferred outflows of resources in the financial statements until the future year to which they are related, at which time they are reported as revenues and expenses and the deferrals are eliminated.

Financial Statement Required Supplementary Information and Notes

25. How will the new standards enhance the usefulness of the information presented in the notes to the financial statements?

Under the new standards, all cost-sharing governments will provide more comprehensive information about their pension plans in the notes to the financial statements. Information that will be required of all governments participating in defined benefit pension plans includes:

- Descriptions of the plan and benefits provided, including changes in the benefits.
- Significant assumptions employed in the measurement of the net pension liability, including information about how the long-term expected rate of return was developed and other factors that affect the discount rate.
- Balances of the net pension liability and deferred outflows of resources and deferred inflows of resources related to pensions.
- An analysis of the net pension liability's sensitivity to changes in the discount rate.
- Descriptions of changes in the assumptions used when measuring the net pension liability.

26. How will the new standards enhance the usefulness of trend information about the net pension liability?

The new standards expand the number of years of historical information that will be provided about pensions, as well as the types of information that will be presented about the liability. Under the prior standards, information was provided covering only three-to-six years. Under the new standards, governments will include RSI schedules, some of which will be built prospectively until 10 years of historical information is presented. Additional years of information will provide a greater historical context for the reported pension information and facilitate trend analysis.

Governments in cost-sharing plans will be required to include schedules with information about the pension liability that they report and relevant ratios. All governments will be required to include notes in the schedules that provide information about factors that significantly affect trends in the schedules.

27. Will users of financial reports still be able to obtain information about plan funding?

Yes. Governments that contribute to a pension plan based on an actuarial valuation or based on statutory or contractual requirements will be required to present 10-year schedules that compare the contribution target to the amount actually contributed by the government, as well as other supporting information. Governments also will be required to disclose information about their funding policy in the notes to the financial statements, including the basis for determining contributions and the contribution rate of the employer and other entities.

Discount Rate

28. What is a discount rate and how does it relate to pension accounting?

A discount rate is an interest rate used to calculate the present value (the value in today's dollars) of projected future benefit payments.

29. What discount rate was used under prior standards?

Prior standards required governments to use a discount rate based solely on the long-term expected rate of return on the pension plan's investments.

30. How is the discount rate determined based on the new accounting standards?

Under the new standards, a government can continue to use a discount rate that is based on the long-term expected rate of return as long as the pension plan's net position that has been accumulated for the benefits of current employees and retirees is projected to be sufficient to make those projected benefit payments ("funded" projected benefit payments). However, if at some future point the benefit payments for current employees and retirees are projected to exceed the amount of plan net position, those projected benefit payments ("unfunded" projected benefit payments) are required to be discounted using an index rate for 20-year general obligation municipal bonds rated AA (or its equivalent) or higher.

31. Will all governments whose pensions are not 100 percent funded be required to discount their projected benefit payments using a municipal bond rate?

No, the funded status of the pensions is not the deciding factor of whether a municipal bond rate should be used. The pension plan's net position is the starting point for making this determination, and a number of variables, such as future contributions into the plan to pay for benefits for current employees and retirees, are considered in the projection of a plan's future net position. As a result, a plan that currently is less than 100 percent funded may, in the future, be projected to have sufficient resources to satisfy those future benefit payments. Conversely, a plan that is relatively highly funded might be required to use a municipal bond rate in determining the discount rate.

32. What is the effect on the government's net pension liabilities of the discounting approach in the new accounting standards?

In the current economic environment, the municipal bond rate generally is lower than the long-term expected rate of return. Therefore, if the municipal bond rate is incorporated into the discount rate, it generally will result in the government using a lower discount rate than if the long-term expected return on pension plan investments was used exclusively. If a lower discount rate is used, the present value of future benefit payments will be greater. Because the measurement of the total pension liability is based on the present value of future benefit payments, a larger present value means a government will report a larger net pension liability than it would have if only the long-term expected rate of return was used. In the future, this dynamic could reverse if the bond yields rise significantly.

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34. What is meant by the "long-term expected rate of return"? Will governments be required to disclose how they determine this rate?

Under the new accounting standards, long-term is intended to reflect a period roughly equal to the number of years between an employee's date of hire and the date when the last pension payment for that employee or the employee's beneficiaries is expected to be made. It does not necessarily mean that the pension plan invests in long-term investments, though that is often the case. Governments will be required to disclose information in the notes to the financial statements about how their long-term expected rate of return was developed.

Net Position

35. How will the recognition of the net pension liability in the year of implementing the new accounting standards affect the net position of a government?

In the first year of implementing the new standards, the net position of many governments is likely to decrease because either (1) they did not report a pension liability of any type in the financial statements or (2) the net pension liability is greater than the net pension obligation that they had reported in the past. In some instances, the net pension liability will be so large that the combined liabilities and deferred inflows of resources exceed the value of the assets and deferred outflows of resources, resulting in a negative unrestricted net position and possibly a negative total net position.

36. What does a negative balance in net position signify?

A negative balance in net position essentially means that the government does not currently have all of the resources needed to satisfy its liabilities. However, it is not necessarily a sign that a government is in dire financial difficulties.

37. In future periods, can a government's net position improve as a result of the changes in the net pension liability?

Yes. For example, the net position of a government might improve due to the effects of an increase in the value of plan investments, which has the effect of reducing the government's net pension liability

Disclaimer

This FAQ document was drafted by the SBCERA staff in order to provide our participating employers with a general explanation of GASB pension standards. Every effort has been made to ensure the accuracy of the information contained in this document. As with any regulatory guidance, information is subject to change, and you should not rely solely on the information contained herein. In the event of any discrepancy, the GASB provisions govern. Employers should consult with their management, professional auditors and actuaries before implementing pension standards. The information provided herein relates only to cost-sharing multiple- employer pension plans, and assumes there are no Special Funding Situations, no Allocated Insurance Contracts, and no Non-Employer Contributing Entities.