New Pension Reporting Standards: Now Is the Time to Prepare

With the deadlines for implementation of new pension reporting standards approaching, it's time to get up to speed.

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New financial reporting requirements for state and local government employee pension plans will significantly affect school districts over the next few years. The new standards change how districts must report pension-related costs and obligations, which in many cases could result in dramatic changes in a district's overall financial picture. With the new standards scheduled for full implementation within two years, now is the time to prepare.

Underfunded Pensions: A Major Concern

In recent years, government agencies, actuaries, public employee unions, and a host of think tanks have begun focusing on the issue of underfunded government employee pension plans. Estimates of the size of the underfunding problem vary significantly—amounts from $1 trillion to $4 trillion are common—but virtually everyone agrees that many state and local government employee pension plans are seriously underfunded and will be unable to meet future obligations without extraordinary investment returns or large infusions of cash.

The severity of this issue will soon become much more apparent. As a result of new pension accounting and reporting standards approved by the Governmental Accounting Standards Board (GASB), these unfunded liabilities will become prominent on either school district financial statements or state financial statements, depending on how the pensions are structured. In some instances, school boards could be required to show millions of dollars in new liabilities on their balance sheets and make sizable adjustments to their income and expenses annually.

Determining how—and how much—your district will be affected is a complex undertaking with a number of variables to consider. With the deadlines for implementation approaching, the time to begin addressing these concerns is now.

New Standards at a Glance

The new standards are GASB Statement No. 67, "Financial Reporting for Pension Plans," which addresses financial reporting for state and local government pension plans, and Statement No. 68, "Accounting and Financial Reporting for Pensions," which establishes new accounting and financial reporting requirements for government agencies that provide their employees with pensions. These statements replace the requirements of GASB Statement Nos. 25, 27, and 50.

GASB 67 will take effect for pension plans in fiscal years beginning after June 15, 2013 (that is, for years ending June 30, 2014 or later). GASB 68 will take effect for government employers in fiscal years beginning after June 15, 2014 (that is, for years ending June 30, 2015 or later).

In broad terms, these standards introduce the following fundamental change: Under previous standards, the obligation to provide pension benefits to retired employees was not reported as a liability. Employers were required to disclose the estimated amount of unfunded pension liability only in notes to their financial statements and in required supplementary information, but the liability itself was not recognized on the face of the balance sheet.

Under the new standards, governments will be required to report their share of the plan's underfunded pension obligations on their own balance sheets. Exactly how that share is determined and the details that must be disclosed will vary, depending on the type of plan in place.

The new standards apply to all types of government employee pension plans—including both defined contribution plans and defined benefit plans. In a defined contribution plan, where the employee is not guaranteed a specific pension amount, determining the employer's liability is relatively straightforward because the liability is generally limited to the amount of the contribution that the employer is contractually required to make.

In a defined benefit plan, on the other hand, the employee is guaranteed a specific payment amount, which is typically related to the employee's ending pay at retirement or the employee's highest pay during the course of a career. The exact size of a pension liability depends on many variables, such as future employee pay scales, retirees' life expectancies, and the future market performance of the invested funds.

Under the new standards, governments will be required to report their share of the plan's underfunded pension obligations on the financial statements prepared under the accrual basis (the statement of net position, for example). Exactly how that share is determined and the details that must be disclosed will vary, depending on the type of plan in place.

Types of Defined Benefit Plans

Defined benefit plans are classified into several categories, which are based on the number of governments participating in the plan and on how the plan's assets and obligations are shared among the participating governments. The new standards recognize the following categories:

- **Single-employer plans.** In this type of plan, the employer is required to recognize the total pension liability, less the amount of plan assets that has been formally set aside for payment of benefits.
- **Multiple-employer agent plans.** In this type of plan, assets are pooled for investment purposes, but a separate account is maintained for each employer. The new reporting requirements are similar to those for single-employer plans because the employer's share of the pooled assets is legally available for only its own employees.
- **Multiple-employer cost-sharing plans.** This type of plan has no separate account for each employer; the plan's assets can be used to pay benefits to retired employees of any participating employer. The employer will be required to recognize a portion of the overall net pension liability. The new liability that must be disclosed will depend on the employer's proportionate share of the collective net pension liability.

Special Funding Situations

The picture is further complicated by the fact that in many states, the state government, rather than the local school district, is legally responsible for making contributions directly to the pension plan. The new GASB standards describe this arrangement as a "special funding situation," which requires a different approach to disclosing the pension liability.

In a special funding situation, a nonemployer contributing entity (the state government) has essentially assumed a portion of the employer's pension obligation as its own. The new standards require the state to recognize its share of the net pension liability and expense in its own financial statements. The agency that benefits from this arrangement (the school district) will be required to recognize its proportionate share of the collective pension expense, but it must also record additional pension expense and revenue to reflect the pension support it receives from the state. In addition, a liability would be recognized for the proportionate share of the collective net pension liability net of the nonemployer contributing entities' total proportionate share.

The new standards contain additional requirements for disclosing other information in the notes to the financial statements. This information includes descriptions of the plan and benefits provided, significant assumptions that were used to determine the net pension liability (such as the presumed discount rate and other investment estimates), and descriptions of benefit changes and changes in assumptions. School districts will also be required to present up to 10 years' worth of special funding situation information as it is compiled in the future.

In addition to the financial statement disclosure changes, the following areas have been significantly updated: timing and frequency of actuarial valuations, disclosure rate requirements, and the required use of the entry-age actuarial cost method to attribute the actuarial present value of projected benefit payments.

How School Districts Should Prepare

The purpose of the new standards is to provide taxpayers and other users of financial reports with a clearer picture of the size and nature of governments' financial obligations to their current and former employees. Reporting net pension liability on the face of the financial statements will also place this liability on an equal footing with other long-term obligations.

In some cases, however, as the GASB acknowledges, these new standards could make a government appear financially weaker than it previously appeared, even though the financial reality of the government's situation has not actually changed. School financial officers should be prepared to explain these changes to stakeholders in a way that clarifies this point.

Administrators should also be prepared for the considerable extra workload.

In the longer term, administrators should also stay informed about any pending proposals that could alter the special funding situations defined under GASB 67 and 68. Faced with their own future new reporting requirements under GASB 68, legislators in several states have discussed revisiting the states' role in funding local school districts' pension obligations. Any change in the way these obligations are handled could expose local districts to even greater liability and expense.

As a practical matter, administrators should also be prepared for the considerable extra workload that will be associated with the transition to the new standards. The implementation deadlines are approaching quickly. And although most of the actuarial calculations and reporting will be performed by plan administrators, school finance officers should be sure they understand which category of plans applies to them and the type of information they will be required to disclose.

The GASB is scheduled to release implementation guidance this summer. Auditors, administrators, and school boards are eagerly awaiting this guidance to clarify their next steps. In the meantime, in view of the significant effect these new standards will have, school finance officers should contact their auditors soon to get a clearer understanding of what will be required.

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