

# HAWKINS ADVISORY

## GASB 68 — Pension Accounting; Pension Disclosure

### **Introduction**

The accounting standards that apply to financial reporting for governmental pension plans (pension systems) and for the governments that sponsor such pension plans have been significantly revised. Governmental Accounting Standards Board (“GASB”) Statement No. 68, “Accounting and Financial Reporting for Pensions,” (“GASB 68”) became effective for governments for fiscal years beginning after June 15, 2014. As a result, for those governments that maintain a July 1 – June 30 fiscal year, GASB 68 will apply to the financial statements for fiscal year 2015 (July 1, 2014 – June 30, 2015). Such financial statements are now being finalized and audited for many of our governmental clients.

This Advisory provides (i) a summary of the key differences between the accounting standards that apply currently to pension plans and to their governmental sponsors, and the standards that have been in effect for approximately the last twenty years, and (ii) a brief analysis of what impact the new accounting standards may have on disclosure in official statements.

### **Standards for Pension Disclosure**

There are three different standards that apply to pension plans and to their governmental sponsors, each of which address related but distinct issues. There are the accounting standards developed by GASB, which govern the financial reporting for the pension plans and their governmental sponsors. There are the actuarial standards developed by the Actuarial Standards Board, which govern the actuarial valuations prepared by pension actuaries. And there are the standards under the federal securities laws, which govern the disclosure in official statements.

### **What GASB Statements now apply?**

GASB Statement No. 25, “Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,” (“GASB 25”) and GASB Statement No. 27, “Accounting for Pensions by State and Local Governmental Employers,” (“GASB 27”) governed financial reporting for governmental pension plans and accounting for their sponsors since June 15, 1996, and June 15, 1997, respectively.

GASB 25 has been replaced by GASB Statement No. 67, “Financial Reporting for Pension Plans,” (“GASB 67”), which became effective for Plan fiscal years beginning after June 15, 2013.

GASB 27 has been replaced by GASB 68, which became effective for Governmental Sponsor fiscal years beginning after June 15, 2014.

### **What are the Key Changes resulting from Implementation of GASB 67/68?**

- Liability Presentation – GASB 25/27
  - Financial Statement Notes showed Net Pension Obligation (NPO), being the cumulative difference between the Annual Pension Cost and the contributions made
  - Annual Pension Cost is equal to (i) the ARC (see below), (ii) one year’s interest on the NPO, and (iii) an additional adjustment factor
  - Required Supplementary Information (RSI; unaudited) showed Unfunded Actuarial Accrued Liability (UAAL) [Assets - Liabilities] and the Funded Ratio [Assets/Liabilities]
- Liability Presentation – GASB 67/68
  - Will be required to *show on balance sheet* of the governmental sponsor the Net Pension Liability (NPL) (also known as “plan net position”), being Total Pension Liability (TPL) net of the pension plan’s assets
- Expense Measurement – GASB 25/27
  - Based on Annual Required Contribution (ARC), being the “normal cost” [present value of benefits expected to be paid in the future attributable to the current year’s employment] plus the amount needed to amortize the UAAL
  - UAAL amortization could be a period up to 30 years
- Expense Measurement – GASB 67/68
  - Changes in the NPL are amortized over varying periods:
  - Immediate expense recognition for interest cost on the pension liability, and differences between expected and actual changes in economic and demographic factors related to inactive/former employees

- Deferred expense recognition over remaining service periods for differences between expected and actual changes in economic and demographic factors related to active employees
- Differences between actual and projected earnings on plan investments would be deferred and recognized as a pension expense over a five-year closed period
- No longer an ARC concept – determination of the amount to fund is solely a matter of policy for the plan sponsor
- Liability Measurement – GASB 25/27
  - Sponsor can select an assumed investment rate of return regardless of the level of assets
  - In actuarial valuation, can use a “smoothing” methodology so that annual payments don’t fluctuate directly with the markets’ annual returns
- Liability Measurement – GASB 67/68
  - Can use a long-term assumed investment rate of return if (i) plan net position is projected to be sufficient to make benefit payments that are projected to occur and (ii) assets are projected to be invested using a long-term investment strategy
  - But at such point that plan net position is projected to be no longer available for long-term investment, must use an assumed investment rate based on a high-quality tax exempt municipal bond index [AA/Aa or higher]
- Miscellaneous – Note disclosures
  - Must show sensitivity of NPL to changes in the assumed investment rate of return, reflecting impact of both 1% higher and 1% lower rate
  - Description of plan, benefits to be provided, contribution policy, authority establishing the plan and requiring contributions to the plan
- Miscellaneous – Required Supplementary Information (RSI)
  - 10 year tables showing changes in TPL and plan net position
  - If sponsor has an actuarially determined contribution (ADC), show ADC, actual contributions made, differences, and resulting ratios
  - If sponsor does not have an ADC, but has statutory or contractual obligations, similar comparative information
  - Significant assumptions underlying the ADC

### **What is impact on Official Statement disclosure?**

SEC has cautioned in enforcement actions that compliance with GASB statements is not necessarily sufficient to satisfy obligations under the federal securities laws. The analysis is the same as for other facts and trends regarding the issuer – is it *material* to an investor? That is, when viewed as part of the “total mix” of information available to the investor, is there a substantial likelihood that a reasonable investor would consider it important to an investment decision?

- Core elements of pension disclosure have not changed. Disclosure should consider addressing the following questions:
  - What are the key actuarial assumptions?
  - What have been the historical annual rates of return?
  - What are the key demographic assumptions?
  - Has there been a recent Experience Study?
  - Does the issuer have a pension funding policy? If yes, what are the significant provisions of any such policy?
  - What are the current and historical funded ratios?
  - Are there projected funded ratios?
  - What are the historical, current, and projected annual pension contributions?
  - Is the annual pension contribution limited/ established by state statute, and are the contribution amounts less than an actuarially determined contribution amount?
  - Are there Pension Obligation Bonds outstanding, and if so, what are the annual debt service payments?
  - Do the annual contributions (both sponsor and members) to the Pension Fund exceed the annual payments from the Pension Fund (disregarding investment earnings)? That is, does the Pension Fund have a positive cash flow?
  - What is the source of payment of the annual pension contribution?
  - Has the sponsor been making the full Actuarially Required Contribution, and if not, why not?
  - What are the respective priorities of the annual pension contribution and the debt service payments on the bonds being offered?
  - Is there a statutory provision regarding the priority of such payments?

- Are the pension payments referenced/protected expressly in the State Constitution?
- For enterprise fund financings, proportionate share of aggregate pension liability borne by a particular fund may represent a small portion of an enterprise fund's annual operating expenses, and therefore not be material
- Even though GASB has moved away from an "Annual Required Contribution," issuer will still need actuary to advise what annual payments would be needed to pay this year's "normal cost" and amortization of any unfunded liability over a specified period of time (referred to as "actuarially determined contribution")
- Is there any current litigation challenging elements of the Pension Plan or how it is being funded?
- Although the key questions outlined above would not change as a result of the implementation of GASB 67/68, what may change is where the disclosures that are responsive to these questions are included, and how to make the clearest presentation to the investor
  - In general, Official Statements would attach (or incorporate) the governmental entity's financial statements, which would comply with the GASB 68 required disclosures
  - In general, would not attach (or incorporate) the plan actuary's Actuarial Report
  - Critical that issuer's notes to the financial statements regarding the pension system be consistent with the analysis of the pension in the body of the final Official Statement

### **OPEB Liability**

Changes comparable to those described above regarding pension liability will also become effective for postemployment benefits other than pensions ("OPEB") liability. In particular, GASB Statement No. 74, "Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans," is effective for financial statements of plans for fiscal years beginning after June 15, 2016, and GASB No. 75, "Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions," is effective for fiscal years beginning after June 15, 2017.

GASB 74/75 will apply to those OPEB plans, both defined benefit and defined contribution, which are administered through trusts that meet the following criteria:

- Contributions from employers and nonemployer contributing entities to the OPEB plan and earnings on those contributions are irrevocable;
- OPEB plan assets are dedicated to providing OPEB to plan members in accordance with the benefit terms; and
- OPEB plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the OPEB plan administrator. If the plan is a defined benefit OPEB plan, plan assets also are legally protected from creditors of the plan members.

Similar to GASB 67/68, GASB 74/75 will require the governmental sponsor to recognize on its financial statements a liability equal to the net OPEB liability. The liability will be measured as the portion of the present value of projected benefit payments to be provided to current active and inactive employees that is attributed to those employees' past periods of service (total OPEB liability), less the amount of the OPEB plan's fiduciary net position.

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