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A Wolf in Sheep's Clothing GASB Changes – Real Disclosure or an Excuse for Benefit Cuts?

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I. WHAT ARE WE TALKING ABOUT?

GASB is the acronym for the Government Accounting Standards Board. It is not a government agency and has no force of law. It is however, the accepted standard for governments, like cities, counties, and states to report their financial assets and liabilities. This is comparable to the NFPA and its guidelines and standards. NFPA is not a government, but its standards are widely adopted, often by legislation, as the applicable standard for fire prevention and safety.

II. WHY DOES THIS MATTER?

All governmental bodies in the United States are required (generally by state law) to issue a Comprehensive Annual Financial Report (CAFR). The CAFR is a snapshot of the financial health of the government, listing its assets and, more importantly, its long and short term liabilities, expected income, cash balances, and expected trends in these areas. These reports

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form the basis of a government's ability to go to the financial markets and issue municipal bonds which are the primary sources of revenue for capital improvements such as fire stations and major fire equipment. Rating agencies evaluate the financial statements and grade the creditworthiness of a government in the same way a bank evaluates and rates an individual seeking loan, such as a home mortgage. The better the credit score of a government, the less interest it needs to pay on bonds to attract buyers.

III. WHAT DOES THIS HAVE TO DO WITH MY PENSION?

Beginning in 2010, GASB began circulating proposed amendments to required accounting disclosures for GASB statements, number 25 and 27. These two particular accounting standards set forth the information which is required in a CAFR about pension liabilities. The proposed changes may have a dramatic effect of the apparent "financial health" of a government and serve as the basis for dramatic plan changes.

IV. WHAT ARE THE PROPOSED CHANGES?

The changes focus on the way pension costs are "recognized" or accounted for annually. They also standardize the actuarial methodology to be used to disclose pension costs. It requires that long term liabilities be measured using a very conservative bond index rather than the current actuarial assumed rates of return. This will increase the focus on the percentage of funding measured against projected liabilities.

V. WHAT ARE SOME SPECIFIC EXAMPLES?

Actuarial Methodology - In a defined benefit retirement plan, which most firefighters are participants in, a member has a contract for a specific percentage of salary, multiplied by years of service, payable for life. In an ideal world, 100% of the money necessary to pay for that lifetime benefit will be in the pension plan on the date a member retires. In order to determine how much that is, the actuary for the retirement plan calculates the projected cost. That amount is determined annually as a percentage of payroll or an actual dollar amount. To do that, the actuary looks at a number of factors such as salary, expected return on investments, mortality, among many others.

Like accountants, actuaries are internally governed by "Actuarial Standards of Practice." Among those standards are various approved methods of determining pension costs. The new GASB provisions mandate the use of the entry age normal method - this is a level percentage of pay over the expected career of the employee. It is the method most widely used for governmental pension plans. For those plans using other methods, however, the plan actuary will have to do a separate valuation using the plan's accepted method of funding as well as the EAN method.

Reporting of the Pension Obligation - The new GASB rules would require reporting of Net Pension Liability (NPL). This is the total liability for accrued and projected benefits

minus the market value of assets and will highlight unfunded liabilities. The current rules only look at the Net Pension Obligation (NPO), which is the Actuarially Required Contribution for a given year minus the actual amount contributed.

The NPL will also be different because future growth of assets will be measured differently. (That will be explained in the next section). The NPL also looks at projected future liabilities. It does not recognize a smoothing of asset gains and losses currently used to determine the "actuarial value" of assets. This means that the current practice of spreading losses and gains to "smooth" out annual fluctuations in cost will not be recognized for accounting purposes. And will highlight the impact of years such as 2008, which was the worst market year since the Great Depression.

Valuation of Assets - Over time, return on investment of pension assets will pay 60% of the cost of benefits. Actuaries assume a certain percentage return on assets. The average annual percentage of asset return being used is between 7.5% and 8% per year. Since 1930, public pension plans have returned a little over 9% per year. Because of recent market conditions, actuaries and many governmental bodies have been lowering the future expectations on earnings. If the assumed rate of return is lowered, the employer cost rises to fill that gap. Here is where the new GASB rules will make a huge impact. Currently, GASB provides the use for present and future liabilities using the assumed rate of return. The new rules will use a blended rate with substantially lower expected rates of return. Projected liabilities not currently covered by actual assets must be assumed to earn only a municipal bond rate of return, which is about half the average assumed rate of return. This will sharply increase the unfunded status of a plan and will increase the projected contribution obligations of the employer. In addition, where many of these cost changes could be deferred or amortized, they will now have to be recognized for accounting purposes immediately. In sum, the current accounting rules focused on long term obligations for funding; the new ones will focus on expensing liability. In addition, the accounting rule change will shift focus from the long term obligation to fund a plan to a short term snapshot of funded status.

VI. WHAT DOES THIS HAVE TO DO WITH EMPLOYER CONTRIBUTIONS?

The short answer is it has nothing legally to do with annual contributions. Funding will be continue to be based on the actuarial valuations done by the individual pension plan actuaries. State law will still require employers to pay the full annually required contribution. (The anticipated effect of apparently greater and more immediate pension obligations is explained in the next section).

VII. IF THE FUNDING OBLIGATION WON'T CHANGE, WHY WILL ALL OF THIS MATTER?

The reporting of financial obligations under the new rules could have the effect of making virtually every retirement plan look underfunded and suggest that downward changes in benefits going forward is urgently needed. It may have the real effect of making the sale of municipal debt more costly, which affects the available funds of a government available for

other cost items such as salaries and related financially based job benefits. It could encourage the greater use of the Florida Fiscal Urgency statute in bargaining and give greater support to prospective benefit changes, even for current workers.

The change in reporting will place greater pressure on employers to increase funding of the retirement plans. While a better funded pension plan, standing alone, is a positive thing, the use of greater current year financial resources of the employer to pay for employee benefits will give credence to those who advocate for benefit reductions. Clearly, this will have a potentially dramatic effect at the bargaining table.

VIII. WHAT IMPACT WILL CURRENT COURT CASES HAVE ON THIS?

Currently, the Florida Supreme Court is considering the case of *Williams v. Scott* which declared the 2010 changes to FRS, as applied to current workers, an unconstitutional impairment of contract and an unconstitutional interference with the right to bargain. A Miami Dade Circuit Court is considering a challenge to the constitutionality of the Fiscal Urgency Law on similar grounds. Those cases will ultimately determine the ability of governments to make unilateral changes in benefits for active employees. Lower benefits for future workers do not present the same constitutional issues.

IX. SO, IS THIS A WOLF IN SHEEP'S CLOTHING OR JUST TRUTH IN ACCOUNTING?

It is probably a little bit of both? Accurate disclosure of governmental financial strengths and weaknesses is essential to the security of the municipal bond market. For that reason, the Association of Municipal Bond Lawyers is issuing its own separate set of pension disclosure obligations. At the same time, pension obligations are not measured in a snap shot, but rather over a 25 year career for the average public safety employee. It makes accountants an increased part of the management of retirement plans. It also unfairly measures liabilities using unreasonably low expected earnings, when over the career of a firefighter, experience has shown returns which fairly mirror the actuarial assumptions.

One thing is certain; once fully implemented in 2013, these GASB disclosures will affect bargaining and future pension benefits.

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