DRAFT

GASB Financial Reporting

Purpose

New Governmental Accounting Standards Board (GASB) reporting requirements under Statement No. 67, *Financial Reporting for Pension Plans*, and GASB Statement No. 68, *Accounting and Financial Reporting for Pensions,* in 2015 changed how public employers in Montana who participate in a public employee retirement plan must calculate and report pension costs and obligations on their individual governmental financial statements. According to GASB, the purpose of these new statements was to "improve the decision-usefulness of reported pension information and to increase the transparency, consistency, and comparability of pension information across governments." [1]

An article prepared by the GASB to explain these new requirements stated:

> It is important to note that the new Statements relate to *accounting and financial reporting* issues only—how pension costs and obligations are measured and reported in audited external financial reports. The Statements do not address how governments approach pension plan *funding*—a government's policy regarding how much money it will contribute to its pension plan each year. While there has been a close relationship between how governments fund pensions and how they account for and report information about them until now, the new guidance establishes a decided shift from the *funding-based* approach to an *accounting-based* approach. The Board crafted its new Statements with the fundamental belief that funding is squarely a policy decision for elected officials to make as part of the government budget approval process.[2]

Why separate reports for each employer?

Under the new GASB statements, the employers who participate in cost-sharing multiple-employer retirement plans (such as Montana's statewide public employee retirement plans) are now required to show pension obligations on their individual financial statements rather than only on a combined financial statement.

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[1] Governmental Accounting Standards Board, *New GASB Pension Statements to Bring about Major Improvements in Financial Reporting*, December 2013. Available online at http://gasb.org/cs/ContentServer?site=GASB&c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160140567

[2] Ibid.

A GASB article explains:

> Through its research, the GASB concluded that the needs of users of information regarding cost-sharing employers do not differ significantly from those interested in single and agent employers. Therefore, the GASB believes it is important to give users of the financial statements of cost-sharing employers access to better, more transparent financial information. Consequently, under the new standards the GASB is requiring that cost-sharing governments report a net pension liability, pension expense, and pension-related deferred inflows and outflows of resources based on their proportionate share of the collective amounts for all the governments in the plan.[3]

Different pension liability numbers

The way that pension liabilities are calculated and shown under the new GASB requirements is different than the way actuaries calculate and show these liabilities for actuarial valuations. Because of these different calculations, the GASB reports may show a higher pension liability than the actuarially calculated liability and therefore also show a lower funded ratio for the plan.

Implications for bond ratings

Because a governmental entity's financial statement is used by credit-rating companies when assessing credit worthiness, there has been concern about how this new reporting requirement will affect government bond ratings. However, credit rating companies have indicated that the new pension disclosures will have limited impact on state and local government credit ratings.

Addressing these concerns, the GASB article explains:

> While this information will, in some cases, give the appearance that a government is financially weaker than it was previously, the financial reality of the government's situation will not have changed. Reporting the net pension liability (or asset, if plan net position exceeds the total pension liability) on the face of the financial statements will more clearly portray the government's financial status because the pension liability will be placed on an equal footing with other long-term obligations.[4]

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[3] Ibid.

[4] Ibid.

Discount rate and investment return assumptions

Under GASB, the term "discount rate" is used when referring to the assumed rate of return on investments because the calculations involve discounting (or translating) the future value of assets and liabilities into present values. The discount rate used for the GASB report will be the same as the actuarial assumed rate of return used in the actuarial valuations as long as the assets are projected (under GASB calculations) to be sufficient to pay the future benefits. However, if the assets are projected under the GASB calculations to be depleted before the benefit liabilities are due, then the GASB discount rate applied after the date of depletion will be the rate of return on a 20-year tax-exempt municipal general obligation bond with a rating AA/Aa or higher. These rates on June 30, 2016, ranged from a high of about 3.1% to a low or about 2.65%.

Sensitivity studies

The new GASB statements also require a section in the financial report showing sensitivity to future experience with respect to assuming a higher or lower discount rate. Actuarial valuations continue to include a similar section on sensitivity to market changes. Again, the pension liability numbers in the GASB report will be different than the numbers in the actuarial valuations due to differences in how assets and liabilities calculated.

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GASB STATEMENT NO. 67 REPORT

FOR THE

MONTANA TEACHERS' RETIREMENT SYSTEM

PREPARED AS OF JUNE 30, 2016

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REPORT OF THE ANNUAL GASB STATEMENT NO. 67
REQUIRED INFORMATION FOR THE
MONTANA TEACHERS' RETIREMENT SYSTEM

PREPARED AS OF JUNE 30, 2016

SECTION I – INTRODUCTION

The Governmental Accounting Standards Board issued Statement No. 67 (GASB 67), *"Financial Reporting for Pension Plans"*, in June 2012. The effective date is for plan years beginning after June 15, 2013. This report has been prepared as of June 30, 2016. Much of the material provided in this report is based on the data, assumptions and results of the annual actuarial valuation of the System as of July 1, 2016. The results of that valuation were detailed in a report dated October 7, 2016.

GASB 67 basically separates accounting from funding by creating disclosure and reporting requirements that may or may not be consistent with the basis used for funding the System.

GASB 67 requires the determination of the Total Pension Liability (TPL) utilizing the Entry Age Normal actuarial funding method. The Net Pension Liability (NPL) is then set equal to the TPL minus the System's Fiduciary Net Position (FNP) (basically the market values of assets). The benefit provisions recognized in the calculation of the TPL are summarized in Schedule B.

Among the assumptions needed for the liability calculation is a Single Equivalent Interest Rate (SEIR), as described by GASB 67. To determine the SEIR, the FNP must be projected into the future for as long as there are anticipated benefits payable under the plan's provision applicable to the members and beneficiaries of the System on the Measurement Date. If the FNP is not projected to be depleted at any point in the future, the long term expected rate of return on plan investments expected to be used to finance the benefit payments may be used as the SEIR.

Paragraph 31.a. (1)-(4): This information is provided in the following table. As stated earlier, the NPL is equal to the TPL minus the FNP. That result as of June 30, 2016 is presented in the following table.

		Fiscal Year Ending June 30, 2016
Total Pension Liability	$	5,483,673,777
Fiduciary Net Position		3,656,830,798
Net Pension Liability	$	1,826,842,979
Ratio of Fiduciary Net Position to Total Pension Liability		66.69%

Paragraph 31.b.: This paragraph requires information regarding the actuarial assumptions used to measure the TPL. The set of actuarial assumptions utilized in developing the TPL are outlined in Schedule C. The total pension liability was determined based on an actuarial valuation as of July 1, 2016, using the following actuarial assumptions:

Inflation	3.25 percent
Salary increases	4.00 to 8.51 percent, including inflation for Non-University Members; 5.00 percent for University Members including inflation
Investment rate of return	7.75 percent, net of pension plan investment expense, and including inflation

Mortality

Mortality among contributing members, service retired members, and beneficiaries:

For Males: 1992 Base Rates from the RP 2000 Healthy Annuitant Mortality Table for ages 50 and above and 1992 Base Rates from the RP 2000 Combined Healthy Annuitant Mortality Table for ages below 50, set back four years, with mortality improvements projected by Scale BB to 2018.

For Females: 1992 Base Rates from the RP 2000 Healthy Annuitant Mortality Table for ages 50 and above and 1992 Base Rates from the RP 2000 Combined Healthy Annuitant Mortality Table for ages below 50, set back two years, with mortality improvements projected by Scale BB to 2018.

Mortality among disabled members:

For Males: RP 2000 Disabled Mortality Table for Males, set forward one year, with mortality improvements projected by Scale BB to 2018.

For Females: RP 2000 Disabled Mortality Table for Females, set forward five years, with mortality improvements projected by Scale BB to 2018.

The actuarial assumptions used in the July 1, 2016 valuation were based on the results of the last actuarial experience study, dated May 1, 2014.

Paragraph 31.b.(1)

(a) **Discount rate**. The discount rate used to measure the total pension liability was 7.75 percent.

(b) **Projected cash flows:** The projection of cash flows used to determine the discount rate assumed that plan member contributions and Employer contributions will be made at the current contribution rates as set out in state statute. These rates are shown in the following page. In addition to these contributions the State will contribution $25 million annually to the System payable July 1st of each year:

(c) **Long term rate of return:** The long-term expected return on plan assets is reviewed as part of the regular experience studies prepared every four years for the System. The most recent analysis, performed for the period covering fiscal years 2008 through 2013, is outlined in a report dated May 1, 2014. Several factors are considered in evaluating the long-term rate of return assumption including long term historical data, estimates inherent in current market data, and a log-normal distribution analysis in which best-estimate ranges of expected future real rates of return (expected return, net of investment expense and inflation) were developed by the investment consultant for each major asset class. These ranges were combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and then adding expected inflation. The capital market assumptions developed by the investment consultant are intended for use over a 10-year horizon and may not be useful in setting the long-term rate of return for funding pension plans which covers a longer timeframe. The assumption is intended to be a long term assumption and is not expected to change absent a significant change in the asset allocation, a change in the inflation assumption, or a fundamental change in the market that alters expected returns in future years.

(d) **Municipal bond rate:** the discount rate determination does not use a municipal bond rate.

(e) **Periods of projected benefit payments:** Projected future benefit payments for all current plan members were projected through 2122.

(f) **Assumed asset allocation**: The target asset allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

Asset Classes	Target Asset Allocation (a)	Long-Term Expected Real Rate of Return* (b)	Long-Term Expected Real Rate of Return* (a) x (b)
Broad US Equity	36.00%	4.80%	1.73%
Broad Int. Equity	18.00%	6.05%	1.09%
Private Equity	12.00%	8.50%	1.02%
Intermediate Bonds	23.40%	1.50%	0.35%
Core Real Estate	4.00%	4.50%	0.18%
High Yield Bonds	2.60%	3.25%	0.08%
Non-Core Real Estate	4.00%	7.50%	0.30%
	100.00%		4.75%
		Inflation	3.25%
		Expected arithmetic nominal return	8.00%

* The long-term expected nominal rate of return above of 8.00% differs from the total TRS long-term rate of return assumption of 7.75%. The assumed rate is comprised of a 3.25% inflation rate and a real long-term expected rate of return of 4.50%.

Setting the Record Straight - Pension Fact Sheet

GASB'S NEW PENSION STANDARDS: SETTING THE RECORD STRAIGHT

The Governmental Accounting Standards Board's (GASB) recent pension standards substantially improve the accounting and financial reporting of public employee pensions by state and local governments. The new standards are:

- Statement No. 67, *Financial Reporting for Pension Plans,* which applies to financial reporting by most pension plans.
- Statement No. 68, *Accounting and Financial Reporting for Pensions,* which applies to financial reporting by most governments that provide their employees with pension benefits.

Below are questions and answers that should help clarify common misperceptions about the new pension Statements.

1. **Do the new GASB Statements establish requirements for how governments should fund their pensions?**

   No. In the past, the accounting and financial reporting standards were closely associated with the approach that many governments take to funding their benefits—that is, toward contributing sufficient resources to a defined benefit pension plan to finance benefit payments when they come due. Consequently, many governments have established funding policies based on the GASB's standards. However, after reexamining the prior standards for pensions, the GASB concluded that approaches to funding are not necessarily the best approach to accounting for and reporting pension benefits. Therefore, the new Statements mark a definitive separation of accounting and financial reporting from funding.

2. **Will governments have to pay more each year for pensions because of the GASB's new Statements?**

   As just stated, the new pension Statements relate only to accounting and financial reporting, or how pension costs and obligations are measured and reported in external financial reports. How much governments actually contribute each year to a pension plan is a policy issue.

Governments will likely report pension expense more quickly than under the prior standards; however, how or whether this information is used in assessing the amounts that governments will contribute to their pension plans is a public policy decision made by government officials.

3. **Do governments have to use a municipal bond rate for discounting as punishment for not fully funding their pensions?**

   No. The selection of an appropriate interest rate for discounting projected future benefit payments to their present value is based on what resources are projected to be used to make those payments: (1) assets of the plan that have been invested using an investment strategy to achieve the assumed long-term expected rate of return and their earnings; or (2) the general resources of the government employer. As long as the projected plan net position related to current employees and inactive employees exceeds the projected benefit payments for those employees, the long-term expected rate of return on investments will serve as the basis for discounting. This asset-based rate is appropriate because the earnings on the plan's investments reduce the amount an employer will need to contribute to the plan.

   If a government reaches a *crossover point*—when projected benefit payments for current employees and inactive employees exceed projected plan net position related to those employees—then benefit payments projected to be made from that point forward will be discounted using a high-quality municipal bond interest rate. This liability-based rate is appropriate because the plan would no longer be expected to have sufficient assets related to those employees to produce investment income that will reduce how much an employer will have to contribute. The pension liability would then resemble the employer's outstanding debt and other typical long-term liabilities.

   However, it is true—all other factors being equal— that the less well-funded a pension plan is, the more likely it will reach a crossover point and therefore have to discount some projected benefit payments using the municipal bond index rate. Under current economic conditions, municipal bond rates are lower than long-term expected returns on pension plan investments. Using a lower discount rate increases the present value of projected benefit payments and, thereby, increases the size of the pension liability.

4. **Do the GASB's standards allow governments to make their liabilities look smaller by using a discount rate based on unrealistically high expected rates of investment return?**

   No. The new Statements require that governments measure their pension liabilities using assumptions that are consistent with the standards of practice of the actuarial profession. If a government assumes a rate of return that is out of line with the actuarial standards, then it is misapplying the accounting standards rather than exploiting a loophole in the standards.

It is important to note that examining a pension plan's investment return in any short-term period is not appropriate for drawing conclusions about the appropriateness of a government's assumption about *long-term* investment earnings. The investment return in any given year or short-term period is likely to be either higher or lower than the assumed long-term return. However, an appropriate long-term investment return assumption will reflect the expected average earnings over a long period, even though it may not be the same as actual earnings in any particular single or short-term period.

Governments will disclose information about their long-term investment return assumptions in the notes to the financial statements to assist in evaluating the reasonableness of those assumptions. The information will include a brief description of how the long-term expected rate of return was determined, significant methods and assumptions used for that purpose, the assumed asset allocation of the pension plan's portfolio, and the long-term expected real rate of return for each major asset class.

5. **Is the discount rate the most important factor in determining the size of a government's pension liability?**

The guidance put forth in the new Statements pertaining to the selection of a discount rate is certainly an important element but it is only one part of the determination. Discounting is one of the basic three steps involved in measuring a government's total pension liability—projecting, discounting, and attributing. (The measurement process is more fully described in separate fact sheets about accounting and financial reporting by governments that provide pension benefits.)

The amount of a government's pension liability also depends on a variety of other factors such as:

- The types of benefits a government has promised
- The length of service of employees and their salaries in the final years of their employment
- The life expectancy of retirees, which determines how long they will continue to receive benefits
- The inflation rate, which affects both salaries and rates of return on investments.

6. **Can the information reported by governments under the new Statements be compared?**

Yes. The comparability of the pension information that will result from the new Statements has been significantly improved. One of the features of the prior standards that many financial statement users have criticized is the variety of choices that employers could make when attributing the present value of projected benefit payments to past, present, and future periods. Governments previously were allowed to select from six different actuarial cost allocation methods, each of which could be applied in two ways—as a level dollar amount each year or as a level percentage of payroll in each year. In the view of many users, these options seriously diminished comparability. The new Statements, however, require that all governments use one type of actuarial cost method—called *entry age*—and apply it only as a level percentage of payroll.

It should be noted that, although governments are required to measure their pensions within the same parameters set forth in the standards, the resulting amounts will be different because of differences in the terms of the governments' respective pension plans, differences in the demographics of the plan members, and differences in other relevant factors. In other words, because the governments are in different circumstances, their measurements will employ different assumptions.

It has been suggested that comparability would be greatly improved if all governments were required to use the same assumptions. However, taking a one-size-fits-all approach would ignore significant differences between governments—such as the mix of their investment portfolios and their actual earnings experience—that are relevant to determining the amount that governments are obligated to provide for pensions.

7. **Has the GASB determined that state and local government pension plans are underfunded by $3 trillion?**

No. The GASB has never conducted research regarding the extent to which pension plans are funded in the aggregate. Funding relates to a public policy issue that is beyond the scope of the GASB's activities.