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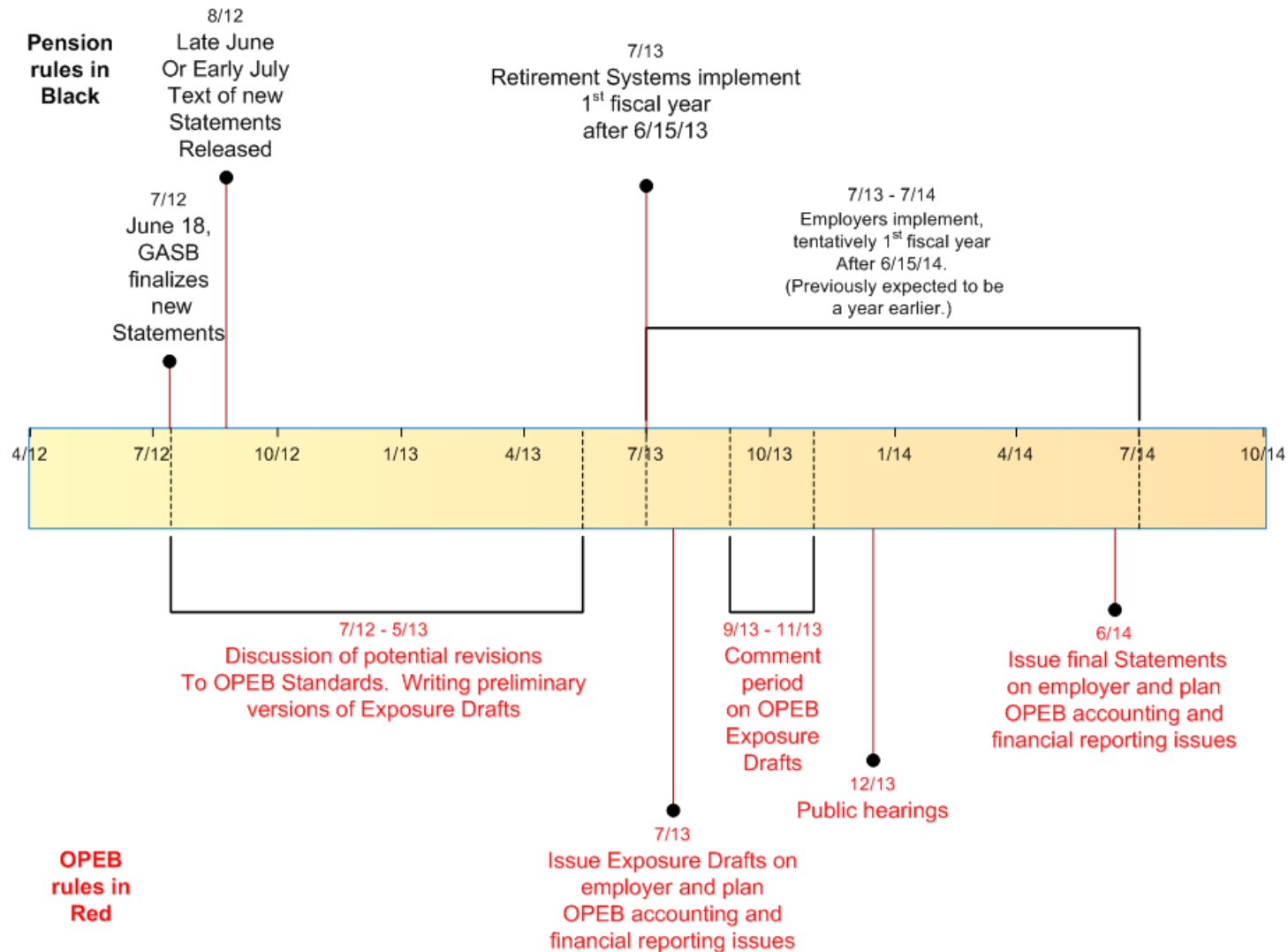
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Practicalities of New GASB Rules

May 3, 2012

New GASB Pension & OPEB Rules Timeline – Updated April 2012



First Southwest Pension & OPEB Timeline: Underlying data: GASB, as of April 19, 2012. Pensions in Black, OPEB in Red

A Quick Overview of California



Retirement Systems and Employers in California

- In addition to CalPERS and CalSTRS, there are at least 80 other defined benefit retirement systems
- University of California
- Local defined benefit retirement systems (source: CA State Controller's Office)
 - 20 “1937 Act” county systems, 1 other county system
 - 32 cities
 - 24 special districts
 - 2 others
- Collectively, these plans serve over 3000 public entity employers

Types of Retirement Systems

	Single Employer (e.g., Los Angeles Fire and Police, City of Fresno Employees Ret System)	Agent Multiemployer (e.g., most larger CalPERS members)	Cost Sharing (e.g., CalSTRS, Sacramento County ERS)
Each employer has its own separate account?	Yes, only one employer	Yes	No ¹
Employer shows employer-specific details regarding its pension assets and liabilities in their annual financials (e.g., Schedule of Funding Progress)?	Yes. In the notes and/or supplementary information under current rules.	Yes. In the notes and/or supplementary information under current rules.	No. Under current accounting rules, there is no reporting of each cost-sharing employer's assets, liabilities, or share of unfunded. Only system-wide assets and liabilities are shown.
Employer shows whether it has made the full annual required contribution under current rules?	Yes	Yes	Yes

1. At CalPERS, cost-sharing risk pools for smaller entities have "side funds", so that members with different funded status can participate in the pools.

Potential Challenges and Problems

Actuaries: Knowledge, Timing, Workload, Cost

- Considerable additional work for actuaries, especially the first time
- Some systems may need additional data from employers, especially if cost sharing (CalSTRS has a presentation on this for its members)
- Most pension actuaries are retained by retirement systems, but some calculations are being done only for employers
 - Similar issues to who will pay for CalPERS to do disclosures for member employers
 - Potential administrative delays, authorization delays if a city, county, or district will need to separately pay for a portion of actuary's work
- By far the most common year ends for both retirement systems and employers are 6/30 and 12/31
 - High peak demand for calculations and services
 - May be good idea to get work done early, avoid the rush
- May be delays completing work due to understanding and/or implementing new rules (as sometimes happened with first reports for GASB 43 and 45)

Auditors: Knowledge, Timing, Workload, Cost

- When GASB 43 and 45 were first implemented, broad range of auditor levels of understanding and helpfulness; this theme may repeat with new pension rules
- Similar concerns as for actuaries: peak demand, many employers asking for similar work at the same time
- There are 80 retirement systems, but there are thousands of public entities in CA doing annual financials
- Staff and auditors for cost sharing employers may have a more difficult learning curve

Increasing Focus on Unfunded Pension and OPEB Liabilities

- S&P states that there are “several notable conditions that, in our view, almost all state and local government issuers will confront. Among these are:
 - An economic recovery that will likely continue to be weak generally;
 - The persistence of budget gaps requiring difficult policy decisions;
 - The potential for a more challenging bond market for issuers;
 - The heightened role of financial liquidity as a credit quality bellwether among municipal issuers, particularly for those with severe structural budget misalignments and issuers of certain types of variable-rate debt;
 - A new regulatory regime as a result of the Dodd-Frank Financial Reform legislation; and
 - An increased focus on issuer pension and other retiree benefits packages.**”
(Jan 24, 2011, emphasis added)
- Moody’s states “Large and growing debt and pension burdens have been, and will continue to be, contributing factors in rating changes. However, unfunded pension liabilities have grown more rapidly in recent years because of weaker-than-expected investment results, previous benefit enhancements and, in some states, failure to pay the full annual required contribution (ARC). Moreover, pension liabilities may be understated because of current governmental accounting standards.” (March 11, 2011)

Balance Sheet Effects

- In “preliminary looks” for various public entities:
 - Proposed rules would mostly have made balance sheets look worse, if rules had been implemented 6/30/11
 - In at least one case, balance sheet looked better
 - Depending on investment results and other factors, effects could be different by implementation date, especially if market value funding ratios exceed 100%
 - CalSTRS members, “unconditional special funding situation”
 - Often large surprises for other cost sharing employers (not used to showing employer-specific unfunded liabilities, even in the Notes)
- Broad range of effects when measured as a percent of assets or net assets
- Rating agencies will have a lot of detail to track, much to learn

What Can Issuers Do Now – Part 1

- Ask your retirement system(s):
 - Will they need additional data from you in future years?
 - Will the new accounting standards likely result in later releases of data, especially the first year of implementation?
 - Do they need additional staff or budget for the new standards?
- Ask your retirement system(s) or their actuary:
 - Who will write the final disclosures for the employer's CAFR?
 - How much will additional calcs and disclosures for the employer cost?
- Review cost estimate vs any requirements for council/board authorization, or RFP requirements
- Ask your auditor:
 - How are they preparing for the new rules?
 - Do they have any materials on the new rules?
 - Do they have a specialist who is working with the new rules?
 - Do they expect difficulty in releasing CAFR at usual time?

What Can Issuers Do Now – Part 2

- Look at your options if required disclosures are expected to arrive later than your usual CAFR release
- Review if CAFR is likely to be filed in 120 days, if you have an EMMA Voluntary Annual Filing Undertaking
- To provide fresher data, consider “off cycle” disclosures to EMMA, e.g., when pension actuarial study or other pension disclosures are completed
- Consider including entire actuarial study as appendix to CAFR, or as separate EMMA filing
- Provide notice to investors regarding potential changes in accounting standards. For example until the standards are issued,
 - *“The Government Accounting Standards Board (GASB) is currently considering changes to pension accounting rules and has released an “Exposure Draft” regarding “the possibility of improvements to the existing standards of accounting and financial reporting for pension benefits by state and local governmental employers and by the trustees, administrators, or sponsors”. An overview of the current status of GASB’s project regarding such potential changes to accounting standards is available from GASB. Any new final accounting standard(s) may result in changes to pension actuarial calculations, accounting for assets and liabilities, or the presentation of such information. These changes may be significant.”*

What Can Issuers Do Now - Part 3

- Start preparing to explain changes to many different parties with different backgrounds, e.g.:
 - Council or board
 - Rating agencies
 - Investors
 - Citizens/taxpayers
 - News media
- Be prepared to explain that the new standards do not directly affect funding or budgets:

“the proposals relate solely to accounting and financial reporting and do not apply to how governments approach the funding of their pension plans. At present, there generally is a close connection between the ways many governments fund pensions and how they account for and report information about them in audited financial reports. The proposals would separate how the accounting and financial reporting is determined from how pensions are funded. Should the proposals become accounting and financial reporting standards in the future, governments would not be required to mirror the accounting and financial reporting changes in their funding approaches.” (Source: GASB’s Exposure Draft Supplement: Plain Language Supplement, June 27, 2011).

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California Debt and Investment Advisory Commission

Pension Project Disclosures

The views expressed in this presentation are those of Mr. Sundstrom. Official positions of the GASB are determined only after extensive due process and deliberation.



Where Have We Been?

- GASB staff research
 - Conducted during 2006-2008
 - Recommended that the Board should place all pension accounting and financial reporting issues on the table
- Invitation to Comment
 - Neutral document
 - Issued in March 2009
- Preliminary Views
 - Board document
 - Issued June 2010
- Exposure Drafts
 - Employers and Plan
 - Issued June 2011



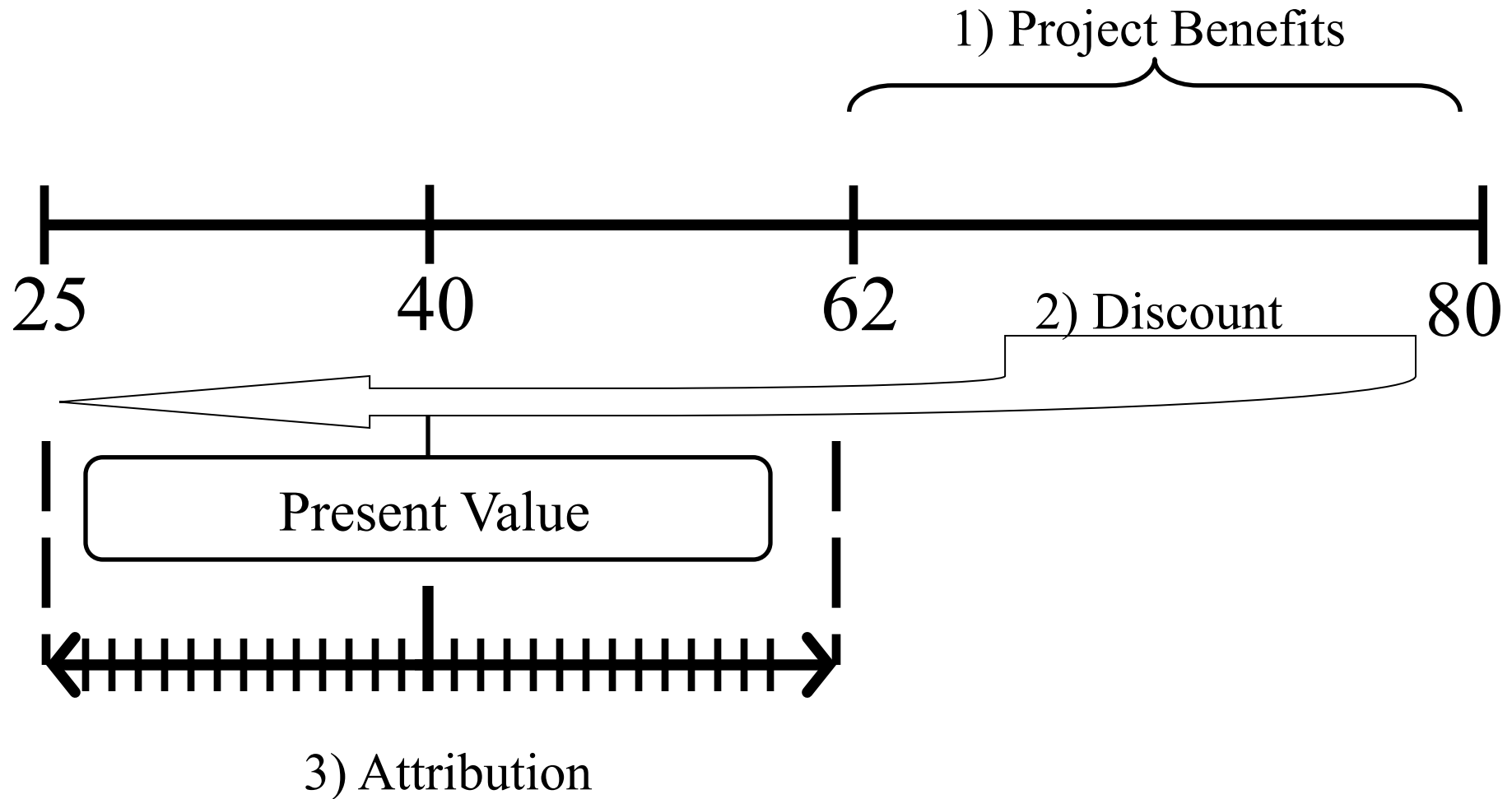
Fundamental Approach

- Balance between a point-in-time measure of the employer's obligation to employees and the measures over time of the cost to taxpayers of providing governmental services
- Viewed in the context of an ongoing, career-long employment relationship
- Accounting-based versus funding-based proposals



Measurement

Measurement Approach Illustrated





Actuarial Assumptions

- Selection of all actuarial assumptions should be made in accordance with Actuarial Standards of Practice (unless specific guidance is provided by the GASB).

Projection of Future Benefit Payments

- The effects of the following projected future changes:
 - Automatic COLAs
 - Projected future ad hoc COLAs when those adjustments are substantially the same
 - Projected future salary increases
 - Projected future service credits



Discount Rate

- Should be a single (blended) rate that reflects:
 - The long-term expected rate of return on plan investments
 - A high-quality municipal bond index rate beyond the point at which plan net assets available for pension benefits are projected to be fully depleted



Crossover Point

- The projection of future employer contributions for purposes of determining a discount rate should **not** include contributions intended to fund the service costs of future employees or the contributions of future employees.



Projection of Contributions

In circumstances in which either

- (1) contributions are subject to statutory or contractual requirements or
- (2) a formal, written policy related to employer contributions exists



Attribution Method

- Single allocation method
 - Based on entry age normal principles
 - employee by employee
 - Level percentage of payroll
 - Starting when employee is first eligible for benefits (before vesting)



Recognition



Statement of Net Position

- Entire net pension liability reported
- Deferred inflows or deferred outflows may be reported based on expense recognition
- Investments measured at fair value



Period Expense Recognition

- Service cost
- Interest on the total pension
- Changes in benefit terms reported in the period of the change



Period Expense Recognition

Closed Amortization over average remaining service lives for

- differences in economic and actual experience for economic or demographic factors
- changes of assumptions about future economic or demographic factors

Retirees included in calculation



Period Expense Recognition

- Projected earnings on plan investments
- Amortization of differences between projected and actual earnings over a closed five-year period



Disclosures



Disclosures

- General information
- Assumptions used in measurement
- Details about changes in the net pension liability, pension expense, and deferred outflows of resources


General Information

- Name of the plan through which benefits are provided
- Identification of the public employee retirement system or other entity that administers the plan
- Identification of the plan as:
 - ☐ Single-employer
 - ☐ Agent multiple-employer
 - ☐ Cost-sharing multiple-employer
- A brief description of the benefit provisions, including
 - ☐ Types of benefits,
 - ☐ Key elements of the benefit formula(s), and
 - ☐ Authority under which benefit provisions are established or may be amended



General Information


- The number of employees covered by the plan, separately identifying:
 - ☐ Retired employees and their beneficiaries
 - ☐ Inactive employees entitled to but not yet receiving benefits
 - ☐ Active employees
- Include all plan's measurements unless the plan is available on the internet

- 
- Assumptions:
 - Salary
 - Inflation
 - Postemployment benefit increases
 - Discount rate
 - Different rates, if contemplated for different periods
 - Date(s) of experience studies and tables on which significant assumptions are based




Discount Rate Assumptions

- Assumptions made about contributions of the employer and of employees and about other projected cash flows into and out of the plan
- Expected rate of return



Discount Rate—Expected Rate of Return

- Expected rate of return on plan investments
- Description of how the expected rate of return on plan investments was determined, including
 - Assumed asset allocation of the portfolio
 - Best estimate of the long-term expected real rate of return for each major asset class



Discount Rate—Municipal Bond Rate (for Blended Rates)

- Tax-exempt municipal bond index rate
- Index selected (20-year maturity)
- Periods of projected benefit payments to which the expected rate of return and the municipal bond index rate were applied to determine the discount rate



Discount Rate—Sensitivity Analysis

- The effects on the current-period net pension liability of a 1-percentage-point increase and a 1-percentage-point decrease in the discount rate

Schedule of Changes in Net Pension Liability

Separately discloses the beginning and ending balances of the total pension liability, plan net assets, and the net pension liability and the effects of:

- ☐ Service cost
- ☐ Interest
- ☐ Retroactive benefit changes
- ☐ Experience gains or losses
- ☐ Changes in assumptions
- ☐ Contributions—employer
- ☐ Contributions—employees
- ☐ Contributions—non-employer entities
- ☐ Net investment income
- ☐ Benefits
- ☐ Refunds
- ☐ Other significant changes



Changes in Net Pension Liability

- Brief description of changes of assumptions
- Brief description of changes of retroactive plan terms
- Employer's contribution policy citing authority under which employer contributions are established or amended.
- Contributions by Non-employer entities
- Basis for employee contributions citing authority under which employee contributions are established or amended.

Pension Expense

Separate identification of:

- ☐ Service cost
- ☐ Interest on beginning TPL
- ☐ Benefit changes
- ☐ Experience gains and losses
- ☐ Changes in assumptions
- ☐ Employee contributions
- ☐ Expected earnings on plan investments
- ☐ Differences between actual and expected returns recognized in current period (1/5 of total)
- ☐ Amort. of beginning def. inflows
- ☐ Amort. of beginning def. outflows
- ☐ Other significant changes

The amortization period or periods for different types of changes in the net pension liability that occurred in the current period

Deferred Inflows and Deferred Outflows

- Separate reconciliations of beginning and ending balances of (a) deferred pension outflows and (b) deferred pension inflows, each with separate identification of changes:
 - Current-period benefit changes
 - Current-period experience gains (losses)
 - Current-period changes of assumptions
 - Earnings on plan investments above (below) expectation
 - Amortization of beginning deferred pension inflows (outflows)



Required Supplementary Information

To Be Deliberated At April
Meeting

Required Supplementary Information

- 10-year schedules for all governments, regardless of type of plan (plus notes):
 - Changes in the net pension liability by source
 - Collective level for cost-sharing employers
 - Components of the net pension liability and ratios: plan net position ÷ total pension liability; net pension liability ÷ covered-employee payroll
 - Collective and individual level for cost-sharing
 - Contribution information, if a government has an actuarially determined contribution: actuarially calculated contribution – actual contributions; contributions ÷ payroll

Illustration: Changes in NPL

	20X9	20X8	20X7	20X6	20X5
Total pension liability					
Service cost	\$ 101,695	\$ 100,317	\$ 103,471	\$ 98,685	\$ 81,657
Interest	231,141	219,193	200,491	185,434	171,179
Benefit changes	-	-	-	-	-
Differences between expected and actual experience	(69,638)	(41,374)	(9,387)	17,438	29,183
Changes of assumptions	-	-	63,375	-	-
Benefit payments	(124,083)	(118,311)	(109,281)	(99,654)	(91,558)
Refunds of contributions	(2,780)	(2,764)	(2,927)	(2,684)	(2,251)
Net change in total pension liability	136,335	157,061	245,742	199,219	188,210
Total pension liability—beginning	3,045,893	2,888,832	2,643,090	2,443,871	2,255,661
Total pension liability—ending (a)	\$3,182,228	\$3,045,893	\$2,888,832	\$2,643,090	\$2,443,871
Plan net position					
Contributions—employer	\$ 109,544	\$ 107,028	\$ 105,755	\$ 103,089	\$ 89,054
Contributions—member	51,119	50,344	54,949	51,926	41,411
Net investment income	199,273	83,235	(30,957)	131,629	236,486
Benefit payments	(124,083)	(118,311)	(109,281)	(99,654)	(91,558)
Administrative expense	(3,427)	(3,333)	(3,046)	(2,684)	(2,349)
Refunds of contributions	(2,780)	(2,764)	(2,927)	(2,684)	(2,251)
Other	8	(34)	37	9	(88)
Net change in plan net position	229,654	116,165	14,530	181,631	270,705
Plan net position—beginning	2,283,333	2,167,168	2,152,638	1,971,007	1,700,302
Plan net position—ending (b)	\$2,512,987	\$2,283,333	\$2,167,168	\$2,152,638	\$1,971,007
Net pension liability—ending (a) – (b)	\$ 669,241	\$ 762,560	\$ 721,664	\$ 490,452	\$ 472,864

Note: Only 5 years are presented here;
10 years of information would be required

Illustration: NPL Components/Ratios

	<u>20X9</u>	<u>20X8</u>	<u>20X7</u>	<u>20X6</u>	<u>20X5</u>
Total pension liability	\$ 3,182,228	\$ 3,045,893	\$ 2,888,832	\$ 2,643,090	\$ 2,443,871
Plan net position	(2,512,987)	(2,283,333)	(2,167,168)	(2,152,638)	(1,971,007)
Net pension liability	<u>\$ 669,241</u>	<u>\$ 762,560</u>	<u>\$ 721,664</u>	<u>\$ 490,452</u>	<u>\$ 472,864</u>
Ratio of plan net position to total pension liability	78.97%	74.96%	75.02%	81.44%	80.65%
Covered-employee payroll	\$ 435,373	\$ 432,256	\$ 426,939	\$ 412,280	\$ 387,055
Net pension liability as a percentage of covered-employee payroll	153.72%	176.41%	169.03%	118.96%	122.17%

Note: Only 5 years are presented here;
10 years of information would be required

Illustration: Contribution-related Information

	20X9	20X8	20X7	20X6	20X5
Actuarially calculated employer contribution	\$ 109,544	\$ 107,028	\$ 105,755	\$ 103,089	\$ 89,054
Actual employer contributions	<u>(109,544)</u>	<u>(107,028)</u>	<u>(105,755)</u>	<u>(103,089)</u>	<u>(89,054)</u>
Annual contribution deficiency (excess)	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Covered-employee payroll	\$ 435,373	\$ 432,256	\$ 426,939	\$ 412,280	\$ 387,055
Actual contributions as a percentage of covered-employee payroll	25.16%	24.76%	24.77%	25.00%	23.01%

Note: Only 5 years are presented here;
10 years of information would be required



Cost-Sharing Employers



Measurement

- Same approach used for the measurement of the collective unfunded liability, deferred outflows, deferred inflows, and pension expense is done for sole and agent employers.

Recognition

- its estimated proportionate share of the collective net pension liability, pension expense, and deferred pension outflows (inflows) with the exception of situations in which another entity has statutory responsibility for the unfunded obligation.
- Basis for Allocation—Proportionate share based on the employer's expected contribution effort relative to that of all employers



Tentative Implementation Dates

- Plans: Years beginning after 6/15/13
- Employers: Years beginning after 6/15/14

Questions?



Web site—www.gasb.org

Disclosure Reporting Standards for Pension Obligations



Alan Milligan – CalPERS

Today's Focus



- ❧ Impact of New Standards on Employers
- ❧ Example of Blended Rate
- ❧ Practical Aspects of Implementation

About CalPERS



Who We Are Impact How We See These Changes

CalPERS



- ❧ Largest Pension Plan in North America
 - ❧ ~\$240 billion in assets
 - ❧ ~1.5 million members and beneficiaries
- ❧ Three main components
 - ❧ State employees
 - ❧ Non-teaching school employees
 - ❧ Local public agency employees
 - ❧ For agencies that have contracted with us

CalPERS



- ❧ About 1500 Local Public Agencies
 - ❧ Counties
 - ❧ Cities
 - ❧ Special districts
- ❧ Two Main Categories of Workers
 - ❧ Safety and miscellaneous (or general)
- ❧ Over 2200 Separate Plans
 - ❧ Some employers have more than one plan

CalPERS



Agent Multiple Employer Plan
or
Cost Sharing Plan?

Both

Impact on Employers



Impact on Employers



1. Pension Expense Will Be More Volatile
2. Unfunded Liability on Balance Sheet
3. Additional Disclosures
4. More Cost to Comply

Pension Expense



❧ More Volatility Due to:

- ❧ Shorter amortization periods for changes
- ❧ Less asset smoothing (in some cases)
- ❧ Blended discount rate sensitive to gains and losses

❧ Implication:

- ❧ Pension funding and accounting will separate (the “Divorce”)
- ❧ Main drawback of changes (but is it really?)

Balance Sheet



❧ Statement of Net Position

- ❧ Entire net pension liability reported
- ❧ Deferred inflows or deferred outflows may be reported based on expense recognition
- ❧ Investments measured at fair value

❧ More Consistency & Enhanced Visibility

- ❧ Main improvement in reporting

Additional Disclosures



❧ From David's Slides:

- ❧ General information
- ❧ Assumptions used in measurement
- ❧ Details about changes in the net pension liability, pension expense, and deferred outflows of resources

❧ More Information

- ❧ Better for detailed users of financial statements
- ❧ Risk of too much information

More Cost to Comply



❧ There Will Be Additional Compliance Costs

- ❧ Additional disclosures
- ❧ More actuarial calculations
- ❧ Staff time and expense

❧ Are the Improvements Worth It?

- ❧ Costs are probably not excessive
(example given later)
- ❧ Additional consistency, visibility & transparency

The Divorce



- ❧ Currently Funding and Accounting are in Lock Step
 - ❧ Pension Expense = Required Contribution
 - ❧ For almost all plans in California
 - ❧ Not true in all states

- ❧ This Will Not Be True in the Future
 - ❧ Balance sheet focus vs. income statement focus
 - ❧ Pension expense will be too volatile to fund
 - ❧ Pension expense will be negative in some years

The Divorce



- ❧ Will this Divorce Have Any Practical Result?
 - ❧ Yes. Recent Phase in Decision by CalPERS Board
- ❧ Will it Have a Long Term Impact on Funding?
 - ❧ Not clear.
 - ❧ Depends on whether a new funding standard is developed
 - ❧ Model Funding Policies Are Being Developed by the California Actuarial Advisory Panel & others

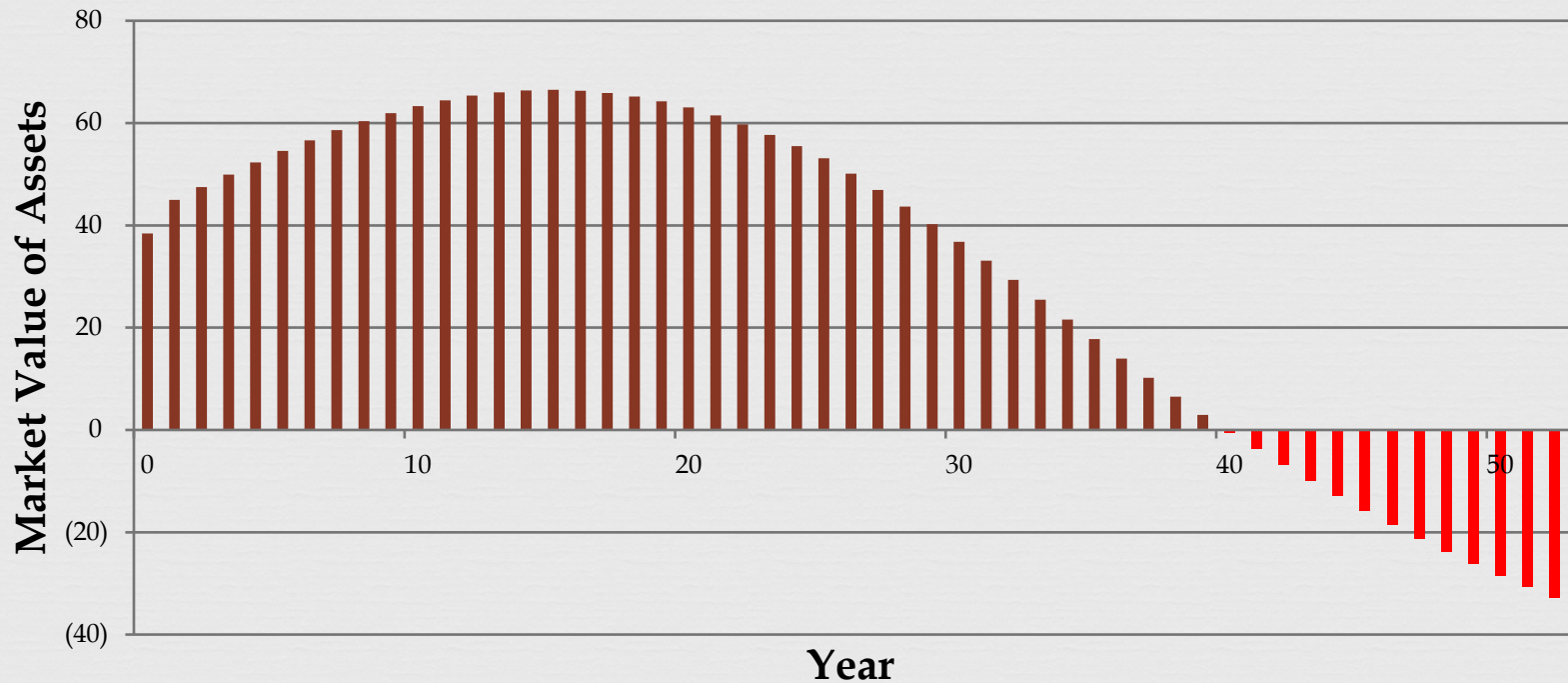
Blended Rate Example



Closed Group Assets



Market Value of (Closed Group) Assets - Current Methods



Blended Discount Rate



- ❧ Crossover in 40 years
 - ❧ Due to open asset smoothing and amortization periods
- ❧ Liability Calculation
 - ❧ 7.5% for benefit payments in first 40 years
 - ❧ 4.0% for benefit payments after 40 years
 - ❧ Lower rate applies for all years, not just after year 40
- ❧ 10% Higher Actuarial Liability
- ❧ Blended Rate is ~ 0.7% lower than funding
 - ❧ 6.9% rather than 7.5%

Alternatives?



- ❧ This is a Lot of Work – Can We Do Something to Make it Easier?
- ❧ Method Changes Could Eliminate the Blended Rate Calculation

Possible Method Change



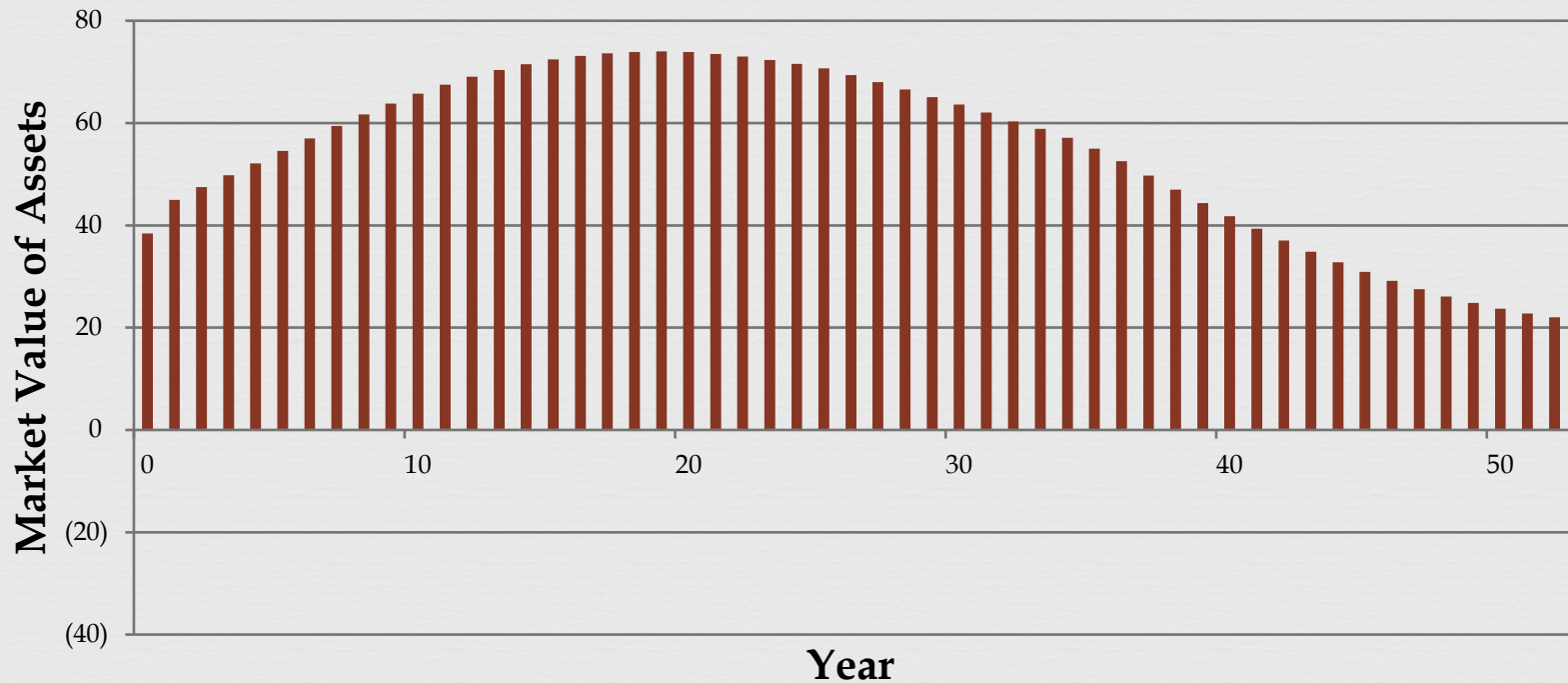
❧ Method Change Examined

- ❧ 30 year closed amortization
(versus 30 year open currently)
- ❧ 5 year closed asset smoothing with no corridor
(versus 15 year open with 20% corridor currently)

Asset Graph w/ Changes



Market Value of (Closed Group) Assets - Method Change



Impact of Change



- ❧ Impact of Method Change
 - ❧ Little difference in short term
 - ❧ Rates do not fall as quickly in the longer term
- ❧ Do Not Have to Do Blended Rate Calculation
- ❧ Report Same Liability for Funding and Accounting

Practical Aspects of Implementation



Current Accounting Disclosures

❧ Actuarial Valuations

- ❧ Prepared by CalPERS annually
- ❧ Accounting information included
- ❧ 16 month delay
 - ❧ June 30, 2011 reports delivered in October 2012
 - ❧ Caused by reporting delays, antiquated systems & sheer volume

Problem #1



Who Does the Actuarial Work?

- ❧ Employer Accounting is *Not* a Trust Fund Expense
 - ❧ IRS rulings, legal opinions, etc.
- ❧ Breach of Fiduciary Duty
 - ❧ Cannot spend trust fund money on non-trust fund activities
- ❧ Cost and Expense of Hiring Consulting Actuary
 - ❧ Are there enough consulting actuaries?

Solution #1



Who Does the Actuarial Work?

- ❧ For Employers In CalPERS, Only One Reasonable Solution - CalPERS Actuarial Office
- ❧ But Funding Needed
 - ❧ Separate charge for employers
- ❧ Mandatory or Voluntary for Employers
 - ❧ Voluntary unless new law or regulation
 - ❧ Employers will have to take the lead

Solution #1



Who Does the Actuarial Work?

❧ How Much Will This Cost?

❧ Ballpark estimate:

❧ If mandatory

❧ ~\$2 million per year/2200 plans = ~\$1,000 per plan

❧ Estimate is probably high

❧ If voluntary

❧ Probably 2 to 3 times the cost if mandatory

❧ Higher if Using a Consulting Actuary

Problems #2, 3 & 4



Timing, Timing & Timing

- ❧ Will CalPERS Have System Changes Ready?
 - ❧ Implementation timeline
- ❧ Will CalPERS Have the Valuations to Employers When they Need Them?
 - ❧ Year end differences & valuation delay
- ❧ Requirement to Have Employers Information as of Their Fiscal Year End

Solutions #2, 3 & 4



Timing, Timing & Timing

❧ GASB Has Been Listening!

- ❧ Change from 24 to 30 months (plus a day)
- ❧ One year deferral for initial implementation (we hope)
- ❧ Employers can report as of plan fiscal year end

❧ Kudos and Expressions of Thanks!

Summary



- ❧ Change is Coming
- ❧ The Pension Expense Will Be More Volatile
- ❧ Pension Accounting and Funding Will Be Separated
- ❧ Better Information Will Be Provided
 - ❧ Consistent
 - ❧ Visible
 - ❧ Transparent
- ❧ Implementation Challenges Have Been Reduced
 - ❧ But Some Still Exist