BILLIONS OF DOLLARS IN PENSION LIABILITIES ARE NOT ON STATE BALANCE SHEETS

As previously mentioned, GASB GAAP did not require states to report any of their unfunded pension liability until 1997. Instead of having governmental entities report all of their unfunded pension liabilities at one time, the GASB allows these obligations to be amortized over 40 years. For example, prior to the implementation of GASB 27, Illinois had underfunded its pension plans by $13.7 billion. Each year $34 million of the pre-1997 under-funding is included in Illinois' Annual Pension Cost. Therefore, as of June 30, 2007, more than $10 billion of pension liabilities for which Illinois became liable for before 1997 are still not reported on its Statement of Net Assets.

The GASB allows state and local governments to amortize benefit increases over 30 years. For example, in fiscal year 2003 the Illinois legislature approved an early retirement option for teachers. While this action increased Illinois' actuarially calculated unfunded liability by more than $2.37 billion,[i] the Net Pension Obligation on the Statement of Net Assets as of June 30, 2003 showed no increase due to this policy decision. The full $2.37 billion became an off-balance sheet liability. The state's FY2003 financial statements also recorded no expense related to this benefit enhancement. Illinois chose to amortize this pension enhancement over 10 years. Therefore the Annual Pension Cost reported on the state FY2005-2007 financial statements was only one tenth of the $2.37 billion. As of June 30, 2007 more than one and half billion dollars of the cost related to this 2003 decision remains off-balance sheet.

Because the GASB allows for a 40 year amortization of pre-GASB 27 underfunding and a 30 year amortization of benefit enhancements, the amount included as the Annual Pension Costs on the financial statements is usually considerably less than the amount the actuaries calculate is needed to adequately fund the pension systems. We are fortunate that the GASB does require the actuarial unfunded pension liability to be disclosed in the Required Supplementary Information. This may allow sophisticated users of the financial reports to approximate the true pension liability owed by some state.

For example, as of June 30, 2007 the Illinois Statement of Net Assets includes a Net Pension Obligation of $14 billion. Information about the state true pension liability is found on page 135 of the Illinois CAFR within the Required Supplemental Information on the Schedule of Funding Progress. This schedule shows three years of actuarial information for each of the five pension plans. To calculate the total pension liability, the Institute had to add together the actuarial unfunded liability for each of the pension plans. The total liability was $40 billion. This means GASB 27 allows $26 billion of Illinois' true pension liability to be kept off-balance sheet.

The calculation of some states' true pension liability is made difficult, if not impossible, because the state is involved in a multi-employer pension system. Under such systems the municipalities and the state have created one system that combines their pension assets and liabilities. Information about the multi-employer pension system is included in the Required Supplemental Information of the state's CAFR. But the state's portion, including its actuarially accrued pension liability, may not separate.

Another complication in calculating a state's true pension liability is that the actuarial valuation date is not in sync with the fiscal year end of the state annual report. The California CAFR for year ended June 30, 2007 is a good example of this problem. The actuarial valuation date for the pension plans is June 30, 2006. This means that the actuarial unfunded liability included in the required supplemental information of the CAFR is outdated.

We also found it disturbing that it is possible for state and local governments to report a Net Pension Asset on its Statement of Net Assets even though they have actuarially determined pension liabilities in millions, if not billions of dollars. This occurs if the government's annual contributions to its pension plan are higher than the annual pension costs, as calculated according the GASB 27 rules. An example of this phenomenon can be found in the 191-page CAFR of the city of Lakeland, Florida for September 30, 2007.[ii] The Lakeland Statement of Net Assets reported a Net Pension Asset of $7.9 million for its employee pension and retirement systems. Within the Required Supplementary Information, on page 100 of the CAFR, the true liability can be found. The Unfunded Actuarial Accrued Liability as of October 1, 2006, the last actuarial valuation date, was $62.4 million.

Another example of the confusion created by pension accounting standards can be found in Texas. On the 2007 Texas Statement of Net Assets there is both a $7.3 million Net Pension Asset and a $421 million Net Pension Obligation. The Net Pension Asset was reported because the state contributions to its Judicial Retirement System Plan II (JRS2) have been greater than the cumulative Net Pension Costs, calculated according to GASB 27, that were reported on the Texas Statements of Net Activities. A review of the state's Schedule of Funding Progress finds that the JRS2 pension system had an unfunded actuarial accrued liability. The truer liability was actually almost $9 million. The Net Pension Obligation was the result of the state funding other pension plans in amounts less than the Net Pension Costs as calculated under GASB 27. We could not calculate the truer pension liability for Texas, because one of the state's six pension plans, Teacher Retirement System of Texas, is a multi-employer plan and the amount included on the Schedule of Funding Progress appears to be the plan's total liability for which the state is only partially responsible.

OTHER POST-EMPLOYMENT BENEFITS ARE NOT REPORTED AT ALL

State and local governments have not been required to report any OPEB liabilities or related expenses beyond the benefits paid to current retirees. GASB 45 will change that starting in 2009. Unfortunately and similar to pension liabilities, very significant amounts of OPEB liabilities will not be reported on each state's *balance sheet*. The amount each state has under-funded its OPEB liability before GASB 45 implementation date in 2007 will not be immediately reported on each state's CAFR. Instead the pre-GASB 45 under-funding will be amortized over 30 years. This means that some states issuing their CAFR for FYE June 30, 2008 will report a little more than one thirtieth of their true OPEB liabilities. Therefore approximately ninety seven percent of these liabilities will be left off -balance sheet.

Some state and local governments have begun using actuaries to calculate their OPEB liabilities. In the 2007 Illinois CAFR, which was issued on June 25, 2008, State Comptroller Daniel Hynes noted, "On April 21, 2008 the State performed an actuarial valuation of the health, dental, vision, and life insurance benefits promised to retirees. The valuation reported a $24.2 billion actuarial liability with no assets currently set aside to fund the liability as the State uses a 'pay-as-you-go' method to make payments to retirees."

Because state and local governments have promised these retirement benefits without setting aside money to fund future payments, OPEB liabilities are enormous. Studies have estimated that state and local governments OPEB liabilities are between $600 billion and $1.6 trillion.[iii] The new accounting standard did not create this under-funding, but fortunately the disclosures required under GASB 45 will reveal them for the first time and make these funding gaps more apparent.

Because so many factors are involved, managing the costs of these health care and other OPEB programs is difficult. State and municipal laws and collective bargaining agreements may make it impossible for public sector employers to act unilaterally. It is also not easy to change employee expectations. Difficulties may be encountered when by trying to get citizens to agree to additional taxes to fund governmental employees' benefits especially during a period when taxpayers are losing these types of benefits from their own private sector employers.[iv]

Since corporations have been required to move from reporting for their OPEB on the pay-as-you-go basis to the accrual basis, many companies have cut back on these benefits.[v] We can only assume this result is due to the change in OPEB reporting requirements, but this certainly brings home the old adage that you can't manage something until you measure it.

Already there is evidence that governments are starting to consider managing their newly calculated OPEB liability. In his CAFR transmittal letter dated March 28, 2008 California's State Controller John Chiang noted that in 2007 he commissioned the state's first actuarial report on OPEB. The report disclosed that the state faces a $47.9 billion unfunded liability. Controller Chiang went on to say, "In January 2008, the California Public Employee Post-employment Benefits Commission, appointed by the Legislature and Governor, unanimously recommended that the state and local governments 'prefund' retiree health benefits by setting aside and investing funds as employees earn OPEB benefits."[vi]

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[i] The Civic Federation, "The State of Illinois Retirement Systems: Funding History and Reform Proposals", *A Civic Federation Issue Brief,* 30 September 2008, Page 14, <http://civicfed.org/articles/civicfed_279.pdf> (Accessed December 20, 2008).

[ii] Lakeland Finance Department, City of Lakeland, Florida, Comprehensive Annual Financial Report of the City of Lakeland, Florida, Fiscal Year Ended September 30, 2007, <http://www.lakelandgov.net/finance/files/C3AFE816BF9D4D1F8CB6B042AF1696FF.pdf> (Accessed December 20, 2008).

[iii] Chris Edwards, and Jagadeesh Gokhale. "Unfunded State and Local Health Costs: $1.4 Trillion." *Tax and Budget Bulletin*, No. 40 (Washington, D.C.: Cato Institute, 2006); David Zion and Amit Varshney, "You Dropped a Bomb on Me, GASB: Uncovering $1.5 Trillion in Hidden OPEB Liabilities for State and Local Governments," *Equity Research, Accounting and Tax* (Credit Suisse: 2007); Brian Whitworth, Igor Balevich, and Jim Kelly, "OPEB for Public Entities: GASB 45 and Other Challenges" (J.P. Morgan: 2005).

[iv] International Society of Certified Employee Benefit Specialists. "Living With GASB 45: How to Manage Liabilities Associated With Retiree Medical Benefits," *Benefits Quarterly*, First Quarter 2008, <http://www.milliman.com/expertise/employee-benefits/publications/published/pdfs/living-with-GASB-45-PA-01-01-08.pdf> (Accessed January 19, 2009).

[v] Credit Suisse.

[vi] California, "State of California Comprehensive Annual Financial Report (CAFR) for the Fiscal Year Ended June 30, 2007," 28 March 2008, Page 10, <http://www.sco.ca.gov/ard/cafr/cafr07.pdf> (Accessed November 15, 2008).