

REVIEW

Net Pension Liability Impact on School Districts after Incorporation of Governmental Accounting Standards Boards (GASB) Statement Number 68

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ABSTRACT

This paper analyzes twenty school districts in the state of Pennsylvania and applies ratio analysis to understand the potential effect of GASB number 68 on the financial statements of these entities. The financial statements were picked on a random basis from the Electronic Municipal Market Access^[1] database. EMMA is a research and data retrieval system of the Municipal Securities Rulemaking Board (MSRB). The MSRB provides resources to trade municipal bonds and access to the financial statements of entities selling these securities.

The paper was developed as a result of the requirement by GASB to “recognize their long-term obligation for pension benefits as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits”^[2].

The public schools in Pennsylvania incorporated GASB number 68 for the fiscal year ended June 30, 2015 and restated the financial statements for the fiscal year ended June 30, 2014. The effects of these restatements created a situation where most of these districts now show a negative fund balance caused by an increase of liabilities of over one hundred percent. Many of the decision makers are uncertain of the long-term changes that this recognition will have on the operations of the school district. Bond ratings have suffered because of the volatility and uncertainty causing negative effects on the balance sheet, increased current recognition of pension expenses, and a possible interest rate increase. All of these effects are illustrated in this paper. This is at a time where many people are questioning the performance of many of the school districts.

1. Introduction

Pension funding for governmental entities after the incorporation of Governmental Accounting Standards Board statement number 68 is experiencing similar problems to the funding of defined benefits in

corporations. Publicly traded corporations were required to recognize these obligations for fiscal years ending after December 15, 2006^[3]. This change in accounting standards created an environment where many companies changed from a defined benefit retirement program to a defined contribution system after the liability of the

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pension fund increased and the shareholders' equity decreased. This change in financial leverage increased the perceived risk factors for these corporations. Many corporations changed from a defined benefit structure to defined contribution plans as a result of the change in accounting principle.

Governmental units will experience an increase in liabilities and a decrease in fund balance because of the additional pension obligation caused by the change in accounting principle. The financial statements in this study show an increase in the funding of pensions along with an increase in liabilities and a deficit in the fund balance. The increase in pension expense may be attributed to the gap in funding that had already existed but had not been recorded. According to a 2013 report by Morningstar using data from the actuarial firm, Milliman "there is a \$1.2 trillion dollar gap in 2012 for the largest 100 U.S. public pension plans"^[4]. This gap was not transparent in past financial statements because the unfunded liability was not stated on the financial statements of these entities. Government Accounting Standards Board statement number 68 requires that all governmental entities record the additional liability on the financial statement starting for financial statements dated after December 15, 2014.

Many states including Pennsylvania have a potential funding issue. The funded ratio varies state to state with 12 states having a funded ratio of at least 80%, 13 states are funded between 70 and 80%, and 25 states are funded at less than the 70% benchmark^[5]. The Pennsylvania Public School Employees Retirement System has a funding rate of 66% while the State Employees' Retirement System has a funding rate of 59%^[5]. The unfunded liabilities of these plans may cause problems including higher interest rates on bonds. Left unsolved, these changes could result in additional cases of municipal distress^[6].

This paper is a study of twenty public school districts picked at random from a list of 596 districts in the state of Pennsylvania. The financial statements for the years ending June 30, 2015 and the June 30, 2014 were used. Governmental Accounting Standards Board (GASB) statement number 68 was incorporated for the June 30, 2015 financial statements and the June 30, 2014 financial statements were restated. We also used the statement of financial position issued as of June 30, 2014 for liability estimates before the effects of GASB number 68. The net pension liability is managed by the Public School Employees' Retirement System (PSERS). The number of employees served by PSERS has increased from 37,000 in 1919 to more than 600,000 today^[7].

2. Analysis of the Pension Requirement on the

Financial Statements of Public School Districts in Pennsylvania

Appendix one, two and three illustrate the effect of GASB 68 on the financial position of the public schools. Appendix one illustrates the difference in liabilities caused by statement 68, appendix two calculates the debt to asset ratio, and appendix three is the debt to assessed value for the districts. The increase in liabilities is caused by the recognition of the obligation to pay pensions as stated in the employee contracts with the school districts. The debt to asset ratios allows the reader to understand the scale of the liability as measured by comparing these obligations to the recognized assets of the entity. The debt to assessed valuation compares the liabilities to the real estate assessed valuations for real estate taxes in the district. Public Schools in Pennsylvania are funded by taxes charged to homeowners and businesses based on the value of their real estate. This is also a controversial item in the state because it provides additional funding for districts in wealthier neighborhoods. Pennsylvania's school districts continue to be highly dependent on the local wealth of their communities to support students' academic achievement due to inefficient state funding^[8].

The analysis of the total liabilities of the twenty schools illustrate the difference caused by GASB number 68. The average total liabilities before the restatement was \$85 million and the average total liability after the restatement is \$177 million. The average difference is calculated to be \$92 million (see Appendix One). The total liabilities remained consistent from the restated 2014 number to the 2015 total of \$177 million compared to \$178 million. The total liabilities of the twenty school districts increased 1.08 times (91,972/84,914) on the average according to Appendix One. District one (the smallest school district in terms of liabilities) increased their liabilities 4.10 times (19,166/4,670) and district nineteen increased their liabilities. 39 times (23,423/59,489). The additional debt posted on the statement of financial position at Pennsylvania Public Schools will also require the state to revise their assessment of school districts that would be designated as part of their financial watch system. The revising of the pension liability will cause schools to be part of the watch because of the change in fund balance ratio, borrowing base capacity, and debt ratio^[9].

The debt to asset ratio before restatement was .738 for the schools in the study. This ratio increased to 1.667 because of the additional liabilities on the balance sheet as the result of GASB #68. The debt to asset ratio was 1.662 in 2015 (see Appendix Two). This ratio allows the financial statement reader to understand the scale as it is related

to the assets of the entity and the increase in the total liabilities as a result of the change in accounting standards. The ratio of .738 to 1.00 means that on the average the districts had less than seventy four cents in obligations for each dollar in assets recognized on the financial statements. The change in standard show that unrecognized liabilities for pension funding is calculated to increase the obligation by almost ninety three cents on every dollar. The districts on average in 2015 are now presenting a balance sheet that has 1.667 times more liabilities than assets. This creates a negative fund balance calculation indicating that the cumulative effect of operation and school funding is negative. This is partially caused by the increase in expenses and recognized liabilities of providing pensions to employees.

The debt to assessed value calculation (Appendix Three) will show the impact of the increased liabilities on the real estate basis the district has for potential funding. The increase from 0.07 (2014 before restatement) to 0.16 (2014 after restatement) indicates that the schools have more than doubled the debt burden as compared to assessed valuation for taxpayers on paper. This liability existed before the restatement but the increased transparency will put pressure on schools to operate with less funds as their taxpayers see the increased amount on the statement of net position to fund public education (kindergarten to grade twelve). This may be problematic in the school districts with lower assessed values for their real estate. Districts with the lower home values will potentially have less funds as the taxpayers may apply political pressure to mitigate the property tax increase. It will also be a potential area of concern for districts with real estate that is not taxed including universities, churches and other not-for-profit entities.

The school districts have always been responsible for the increased liability but the unfunded liability was not recognized until the fiscal years ended June 30, 2015 with a restatement of the June 30, 2014 financial statements for comparative purposes. These differences illustrate that the volatility caused by the change in reporting for pensions will be uneven in the different governmental entities even within similar types of entities. This transparency may cause certain school districts to face additional financial scrutiny as their statement of financial position is not as strong when you benchmark the numbers to other districts. In most cases the changes caused by these increased liabilities are consistent from the 2014 restated numbers to the 2015 liabilities. The assets of the district will not change based on the incorporation of the new standard but the net position will change in proportion to the change in recognized liabilities.

The average net position decreased after the restatement of the liabilities to a negative fund balance of an average of \$68 million dollars (see Appendix Four). This balance remained constant for the 2015 fiscal year. The decrease in net position of \$90 million dollars is equivalent to the increase of total liabilities of \$92 million dollars for the restatement caused by Governmental Accounting Standards Board Statement number 68. Several other items were also restated on the financial statements causing the difference of approximately \$2 million dollars.

The change in fund balance is significant but each of the school districts showing a negative fund balance may cause the policy makers to consider alternatives to the current funding or possibly raising taxes. The local election results may give an indication of the stance of the various parties to this negative fund balance issue across the school districts. This decrease in fund balance will also effect other state and local governmental agencies that have a significant liability caused by pension obligations.

School districts before the incorporation of GASB #68 struggled to balance the budget and possibly have a fund balance as a financial cushion for a downturn in the economy. This will be even more difficult with the recognition of these additional liabilities. "Fueled by cuts in state funding and dramatic increases in pension costs some districts have depleted their fund balances just to balance budgets and avoid laying off teachers. School Districts should keep a fund balance of 5 to 10% of their total budget"^[10].

Governmental and Financial Accounting standards take a long time to go into effect. These standards are vetted by the preparers of financial statements and many of these firms will estimate the effects on the financial statements of the incorporation of the new standards. Brown, Schultz, Sheridan and Fritz prepared a statement in January, 2014 detailing the potential effects of GASB # 68. The table within the article stated that the accrued liabilities for pensions in 2012 were \$87.8 billion, the actuarial value of the assets calculated at \$58.3 billion, and the unfunded liability was calculated at \$29.5 billion. The funding ratio from the period 2003 to 2012 decreased from 97.2% to 66.4%^[11]. The problem increased significantly from 2003 to 2012 and the funding of the school districts pension obligation was deteriorating even before the incorporation of the new standard in 2015.

The pension contributions have increased from 2014 to 2015 (Appendix Five). This may be the result of the recognition of the funding status on the statement of financial position or as a result of a need to address the funding issue that has developed starting in 2003 (see previous paragraph). Most school districts in central Pennsylvania

are looking to raise taxes next year at a rate of five, six, or seven percent^[12]. The article discusses various reasons for the tax increases and one of the reasons is rising pension costs. School districts were able to defer funding the rising costs of pensions as evidenced by the 2003 to 2012 funding decrease of 30%. The transparency of the new standard is forcing these districts to address the issue.

3. Conclusion

The challenges of funding a defined benefit plan is that the risk is assumed by the governmental entity. The pension assets of governmental entities depend on the investment strategy of the fund along with the promised benefits of the benefit. The analysis of total liabilities and net position indicate that the change in reporting pension liability will create an additional \$90 million dollars of recorded obligations on the balance sheet and a negative fund balance for the school districts. These obligations were not recorded prior to 2015 but the future payments were going to be paid when the employees retired. This obligation was being paid in the past based on a growth model for the school districts. The number of employees retiring is increasing as the demographics of the state have changed.

The funding of the pension expense has been decreased from 97% in 2003 to 66% in 2012. Pension analysts note that the shortfall was increased because of the epic market collapse of 2008^[13]. The state has recognized this problem and it has resulted in a delay in the 2015 state budget. One of the items being discussed is to create a retirement plan based on a defined contribution with the state providing matching funds. This plan was not enacted for the 2015 and 2016 budget. The hybrid plan was passed for the 2018 Illinois budget^[14]. The 2016 -2017 Pennsylvania budget resulted in a \$345 million increase in pension funding to a level of \$2.064 billion^[15].

The debt to assessed value has more than doubled and many lawmakers are questioning the fairness of a system based on property taxes. One of the problems with his method is the unequal funding of schools. The additional liabilities may cause budget cuts or increased taxes. The growth model was able to defer many of these issues. Governmental Accounting Standards Board Statement # 68 is providing a transparent view of the potential problems with the funding of pension obligations possibly removing the ability to defer the issues of pension funding to a future period.

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Appendix One

Analysis of Total Liabilities

numbers in thousands of dollars	Total Liabilities-2015	Total Liabilities-2014	Total liabilities -2014 before restatement	difference between 2014 total liabilities
District one	23,188	23,836	4,670	19,166
District two	58,718	59,149	22,388	36,761
District three	138,166	129,071	70,056	59,014
District four	419,849	386,599	240,915	145,684
District five	549,160	588,147	234,144	354,004
District six	44,486	45,853	22,048	23,805
District seven	260,891	245,617	71,887	173,730
District eight	51,475	54,465	16,231	38,234
District nine	62,829	63,683	32,244	31,439
District ten	30,861	31,881	11,156	20,725
District eleven	87,007	91,805	36,336	55,469
District twelve	65,972	61,600	25,371	36,229
District thirteen	42,530	42,043	17,440	24,603
District fourteen	670,133	625,614	339,215	286,398
District fifteen	89,805	92,469	47,030	45,439
District sixteen	178,183	188,180	83,629	104,551
District seventeen	407,271	416,206	203,911	212,295
District eighteen	221,096	225,110	112,781	112,329
District nineteen	91,959	82,912	59,489	23,423
District twenty	81,842	83,490	47,344	36,146
Average	178,771	176,886	84,914	91,972

Appendix Two

Debt to Asset Ratio

School District	Debt to Assets-2015	Debt to Assets-2014	Debt to assets 2014 before restatement
District 1	2.481	2.535	0.497
District 2	1.201	1.192	0.451
District 3	1.579	1.430	0.776
District 4	1.388	1.252	0.780
District 5	2.109	2.269	0.903
District 6	1.307	1.341	0.645
District 7	1.518	1.600	0.468
District 8	1.485	1.574	0.469
District 9	1.618	1.614	0.817
District 10	1.533	1.600	0.560
District 11	2.922	2.925	1.158
District 12	1.235	1.197	0.493
District 13	1.360	1.300	0.539
District 14	2.091	2.175	1.179
District 15	1.717	1.485	0.755
District 16	1.407	1.462	0.650
District 17	1.453	1.441	0.706
District 18	1.442	1.475	0.739
District 19	1.333	1.394	1.000
District 20	2.051	2.083	1.181
	33.230	33.345	14.768
	1.662	1.667	0.738

Appendix Three**Debt to Assessed Valuation**

School District	Debt to Assessed Valuation -2015	Debt to Assessed Valuation - 2014	Debt to assessed valuation before restatement - 2014
District 1	0.215	0.236	0.046
District 2	0.073	0.074	0.028
District 3	0.170	0.159	0.086
District 4	0.658	0.602	0.375
District 5	0.110	0.122	0.049
District 6	0.277	0.289	0.139
District 7	0.053	0.051	0.015
District 8	0.055	0.043	0.013
District 9	0.099	0.102	0.052
District 10	0.218	0.226	0.079
District 11	0.356	0.376	0.149
District 12	0.076	0.071	0.029
District 13	0.126	0.127	0.052
District 14	0.163	0.153	0.083
District 15	0.053	0.055	0.028
District 16	0.083	0.089	0.040
District 17	0.071	0.073	0.036
District 18	0.090	0.093	0.046
District 19	0.069	0.064	0.046
District 20	0.145	0.154	0.088
Average	0.16	0.16	0.07

Appendix Four

Analysis of net position

School District	Total Net Position-2015	Total Net Position-2014	Total net position -2014	Difference in
in thousands of dollars			before restatement	net position - 2014
District 1	(13,570)	(13,491)	4,732	18,224
District 2	(8,314)	(7,619)	27,215	34,834
District 3	(49,168)	(49,776)	20,187	69,963
District 4	(110,662)	(109,874)	67,800	177,674
District 5	(300,044)	(305,072)	25,083	330,155
District 6	(11,157)	(11,731)	12,135	23,866
District 7	(88,107)	(82,630)	81,629	164,260
District 8	(16,673)	(17,901)	18,372	36,272
District 9	(23,131)	(22,474)	7,215	29,689
District 10	(10,949)	(11,027)	8,765	19,792
District 11	(58,428)	(57,769)	(4,945)	52,824
District 12	(11,700)	(8,314)	26,074	34,388
District 13	(11,438)	(9,535)	14,895	24,431
District 14	(312,751)	(310,487)	(51,601)	258,887
District 15	(36,180)	(37,595)	15,235	52,831
District 16	(50,783)	(52,504)	45,074	97,578
District 17	(121,846)	(117,728)	85,015	202,743
District 18	(66,994)	(66,811)	39,862	106,672
District 19	(21,925)	(21,523)	17,963	39,486
District 20	(41,675)	(40,476)	(7,257)	33,219
Average	(68,275)	(67,717)	22,672	90,389

Appendix Five

Pension Contributions

District	Pension Contributions	Pension Contributions	Increase in Pension	percent increase
thousands of dollars	2015	2014	Contribution 2014 - 2015	2014 - 2015
District 1	1,174	948	226	24%
District 2	2,428	1,805	624	35%
District 3	4,697	3,732	964	26%
District 4	12,215	12,530	(315)	-3%
District 5	21,764	17,690	4,074	23%
District 6	1,709	502	1,207	240%
District 7	11,482	9,214	2,268	25%
District 8	2,604	1,805	799	44%
District 9	2,110	1,648	462	28%
District 10	1,381	1,053	327	31%
District 11	3,645	2,799	846	30%
District 12	2,450	1,948	503	26%
District 13	1,906	1,430	476	33%
District 14	19,578	15,281	4,297	28%
District 15	3,026	2,255	771	34%
District 16	6,371	5,412	959	18%
District 17	13,957	10,649	3,308	31%
District 18	7,466	5,985	1,481	25%
District 19	2,681	2,094	587	28%
District 20	2,322	1,831	491	27%
Average	6,248	5,031	1,218	38%