Interpreting an Employer's Net Pension Liability

By Stephen J. Gauthier

The amount of the net pension liability that state and local governments recently stared reporting can be substantial, and in some cases may even dwarf an employer's other liabilities.

Starting with the fiscal year that ended June 30, 2015, state and local governments began to report a *net pension liability* (NPO) on their government-wide statement of net position, in conformity with GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*. This new pension liability represents the difference between the value in today's dollars (present value) of benefits already earned by employees (*total pension liability*) and resources accumulated and held in trust to pay those benefits (*fiduciary net position*). The amount of the NPO can be substantial, and in some cases may even dwarf an employer's other liabilities.

Because government employers previously have not reported an NPO, some financial statement users who are encountering it for the first time may be unsure how to assess its significance. This article offers three points of reference for making that assessment: 1) funding policy; 2) funding progress; and 3) funded contributions.

Funding Policy. There is no need for the parents of a kindergartener to panic just because they have not yet accumulated in their child's college fund all of the money that will be needed to pay for the child's college education. After all, the parents still have 12 years to accumulate the total resources that will be needed. What is important is that: 1) the parents have a solid plan for accumulating the necessary resources; 2) the plan they have put together is feasible, given the parents' financial circumstances; and 3) the parents faithfully follow that plan by faithfully making their contributions to the college fund in full. So too, there is no reason to fear serious financial difficulties simply because a government employer has not yet accumulated the total resources that will be needed to pay benefits when current employees retire if: 1) the employer has a plan to make contributions based on an actuarial valuation that uses reasonable assumptions; 2) it is feasible for the employer government to keep making those contributions, given its economic circumstances; and 3) the employer government does, in fact, faithfully pay the full amount of its *actuarially determined contribution* (ADC) to the pension plan each year. To use another analogy from personal finance, the important thing is not so much the size of the mortgage on the house, as the size of the monthly mortgage payments and the homeowner's ability to make those payments given the homeowner's income.

Funding Progress. Another factor in evaluating the significance of an employer's NPO is the plan's *funded ratio*, which compares amounts accumulated in trust (*fiduciary net position*) to the employer's *total pension liability*.

Assume, for example:

Total pension liability	$100
Fiduciary net position	(85)
Net pension liability	$15

The *funded ratio* in this case would be 85 percent ($85 fiduciary net position/$100 total pension liability = 85 percent).

The funded ratio is a widely quoted metric for assessing the soundness of pension funding. When considering the funded ratio, however, context is important. Assume, for instance, the following facts:

	Funded Ratio	
	Pension Plan A	Pension Plan B
2016	80 percent	85 percent
2015	79 percent	87 percent
2014	77 percent	90 percent
2013	74 percent	92 percent
2012	71 percent	93 percent
2011	70 percent	95 percent

If a reader considered only the current year's funded ratio, Pension Plan B, with 85 percent funding, is clearly in the better funded position. However, an examination of trends over the past five years offers a very different perspective. The funded ratio for Pension Plan B has been steadily declining during the five most recent years (even though it is still ahead of Pension Plan A), whereas just the opposite has been happening for Pension Plan A. Consequently, those interested in pension plan funded ratios should consider trends over time in making their assessment. While a plan's funded status today is important, the *speed* and *direction* of change are equally important.

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Funded Contributions. All accepted actuarial funding methods will generate actuarially determined employer contribution amounts sufficient to provide all the resources needed to pay promised benefits on time if the underlying assumptions hold true. Consequently, if employer contributions are actuarially determined, employers should be contributing that full amount each year to the pension plan. Required supplementary information (RSI) that immediately follows the notes to the financial statements provides trend information on actuarially determined contributions and actual employer contributions for the current year and previous years. A pattern of 100 percent funding should be the norm.

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This article draws on GFOA's recent publication: Interpreting Local Government Financial Statements: How To Avoid 25 Common Mistakes, *which was released earlier in 2016.*