Overview Brief: Net Pension Liability and the Relationship to the Fund Balance

August 28, 2020

I. Summary

On June 9, 2020, Dr. Howard Bunsis, a professor at Eastern Michigan University hired by the Western Oregon University Federation of Teachers, presented an analysis of Western Oregon University's fiscal year 2019 audited financial statements.[1] As part of that analysis, one of the claims Dr. Bunsis made was that the University's net pension liability, a noncurrent liability, is really the state's (or primary government's) liability by virtue of being reported in the state's yearly Consolidated Annual Financial Report (CAFR); and therefore, the university's audited financial statements could be viewed through a lens that excludes the liability.

II. The university's net pension liability is real and is appropriately recorded on the university's statement of net position

Management does not dispute that the noncurrent liability is reported on the state's CAFR. In fact, the university's entire statement of net position, which is colloquially known as the balance sheet, is reported in the CAFR, including all of its liabilities and even its assets. What is disputed is that the net pension liability is not really the University's liability and that it is also included as a "roll-up" of the state's noncurrent liability.

As the University is a discretely presented component unit (DPCU) of the State of Oregon, the university is subject to *all* of the Governmental Accounting Standards Board (GASB or Board) statements, including statements 68, 71, and 75. While these statements were adopted by the Board in the last decade, the Board's goal was to improve accounting and financial reporting for pensions by, among other things, disclosing the assumptions the primary government—that is, the State of Oregon—uses in its measurement of the liability across executive agencies, boards, commissions, and discretely presented component units such as universities. In fact, all local governments follow the same practice as described here. As a DPCU, the University recognizes on its statement of net position the proportional share of the net pension liability based on those assumptions made by the primary government.

The Board defines the net pension liability as the difference between the present value of the projected benefit benefits to employees based on their past service and the assets, reported in terms of fair market value, in the pension. In essence, the liability is the recognition of the portion of the pension that is unfunded. Before the Board adopted the Statements, this value was previously referred to as the unfunded actuarial accrued liability. So, the net pension liability the University recognizes is merely a fraction of the entire pension's unfunded actuarial liability.

Of course, all liabilities should eventually be extinguished or amortized. With respect to the net pension liability, the primary government's goal is to amortize the net pension liability. This can

[1] The university's independent auditor is Eide Bailly LLP

be performed a number of different ways, to include (1) strategically placing investments such that they outperform the pension's actuarial assumptions, (2) requiring increased employer contributions from the pension's members, or (3) changing the terms of a pensioner's benefits, where permissible by law. In underperforming markets or asset classes, in which the pension is vested, the net pension liability is amortized by increasing the rate an employer must contribute for each dollar paid to the employee.

As the present value of the projected benefits to pensioners swells, the need for more resources in future periods will increase, rendering labor much more expensive each year in non-inflated dollars. The incremental increases in resources will amortize the net pension liability slowly as long as the pension bests its own assumptions. If the pension does not perform, governments and DPCUs, such as our own university, will be mandated to pay more for each dollar paid to an employee.

Dr. Bunsis' second claim is that the university's net pension liability is reported on the state's CAFR. This is true to the extent that is reported somewhere in the CAFR but not to the extent that it is reported as part of the *primary government's* statement of net position. In fact, all other public universities, which are DPCUs of the primary government, report their own share or portion of the pension's unfunded liability as their own net pension liability. There is no "roll-up," and the state makes clear that executive agencies, boards, and commission and other executive governing bodies exist and are presented separately from local governments, counties, and discretely presented component units.

A. The relationship between the university's liabilities and fund balance

Much like balance sheets for private firms, a public university's statement of net position reports net assets (equity) such that assets and deferred outflows of resources are subtracted by liabilities and deferred inflows of resources. However, two key distinctions can be observed in the juxtaposition between a balance sheet and a statement of net position. The first is that, on a balance sheet, equity is seldom classified into separate components. The statement of net position (or net assets), however, classifies the difference between the net capitalized costs of capital assets after accumulated depreciation and the underlying liabilities; it is only one of the many captions one may find in the breakdown of net position. In the statement of net position, this treatment of capitalized assets is called the investment in capital assets, net of accumulated depreciation. The net position is further classified into restricted and unrestricted classifications depending on the contractual nature of the net assets for which the classification exists.

Before net position is classified into the myriad components, fund balances across the entire organization must be calculated. The formula is very simple. The current fiscal year's difference between revenues and expenditures is added to the beginning fund balance of the current fiscal year, which is the same as the ending fund balance of the prior fiscal year. Changes to liabilities and assets, with few exceptions, have commensurate changes to revenues and expenditures.

Consider the university's net pension liability. In fiscal year 2020, the Department of Administrative Services determined that the university's pro-rata share of the liability increased by almost 3.4 million dollars to 37.2 million dollars. An increase (credit) to the liability represented a reciprocal but commensurate increase (debit) to the fiscal year's pension expense. While cash played no part in the recognition of the liability, fund balance was certainly reduced because expenditures increased.

Consider another example where assets are observed to have changes in a fiscal year. When tuition is assessed in each academic term, accounts receivable increases (debit) while revenues increase (credit) too. In this example, changes to the fund balance are recognized where accounts receivable experience changes and not necessarily where receipt of cash extinguishes the accounts receivable balance. Because revenues increased, the fund balance will increase concomitantly. This reflects, just as it did in the prior example, the university's accrual-basis of accounting.

Fund balance is not cash or cash equivalents. It is not a measure of liquidity. It simply represents the changes between revenues and expenditures that may have corresponding changes to the university's assets or liabilities. While fund balance is not a good measure of liquidity or liquid assets, the changes to the fund balance are indirectly related to the university's economic performance in some fiscal year.

III. Conclusion

The net pension liability cannot be excluded from the university's statement of net position. The liability is, in fact, very real and is amortized over future periods. It has immediate consequences on the university's fund balance, and financial managers are dutybound to carefully consider a liability's effect on the fund balance. For more information, please see 6, 10, 14 notes to the financial statements.