

## **ACC 545 Governmental Case (Completed in Pairs as Shown on D2L)**

The primary objective of this case is to enhance your understanding of governmental financial reporting through a detailed analysis of the Comprehensive Annual Financial Report (CAFR) for the State of Illinois and its pension-related disclosures. The case chronicles a large increase in the State's unfunded pension liability since 1973 and largely unsuccessful legislative measures taken to stem its growth. This provides an opportunity to examine governmental accounting in a striking real-world setting. You will examine the State's CAFRs from multiple perspectives – of taxpayer/citizen, state legislator, and investor – and will compare it to another state's CAFR. We pay particular attention to pensions because you spend substantial time in intermediate accounting courses studying accounting for defined benefit pension plans for corporate entities. However, defined benefit plans are becoming less important in corporations. On the other hand, they are common in state and local governments, and state legislatures expend considerable resources in assessing the funding requirements of these plans. Further, an analysis of pension liability and expense are essential to any assessment of a state's financial condition due to the large numbers involved.

Pension computations are very complex. Most voters and policy-makers do not understand them, which leads to decisions with potentially large and unexpected consequences. Accountants have the responsibility to assess and communicate the financial position of governmental entities, yet a majority of accounting majors are not sufficiently familiar with CAFRs, which contain a wealth of useful information but are voluminous and hard to read. Current accounting standards require governments to recognize the net pension liability and pension expense on government-wide financial statements. However, these items do not appear as line items on the Statement of Net Position and Statement of Activities of many entities even when material, and need to be searched in the footnotes.

## **Introduction**

Illinois is the fifth-largest state in the U.S. in population and gross state product (the state version of GDP). Services provided by the state include education, social and health services, construction and maintenance of highways, public safety, conservation of natural resources, economic development, and recreation facilities. Governmental activities of the state are funded primarily through taxes. The State of Illinois has a vigorous service sector with strength in professional and business services, education and healthcare services, and leisure and hospitality services. The largest private employers in the State include retailers, healthcare providers, equipment manufacturers, and nationwide financial service providers.

Economic growth continued at a steady pace in Illinois during fiscal year 2017, with measures of economic activity showing gradual improvement after a sharp decline in 2009 and 2010. The average Illinois unemployment rate decreased from 6.2% and 6.0% in fiscal years 2015 and 2016, respectively, to 5.0% at June 30, 2017 (Illinois 2017, 29).

Illinois' Comprehensive Annual Financial Report (CAFR) for 2017, however, indicates deep financial woes and a significant deterioration in the State's financial condition during the year. The deficit for net financial position of governmental activities increased from \$131.57 billion on June 30, 2016, to \$141.66 billion on June 30, 2017 (Illinois 2017, 33). This deficit, computed on an accrual basis, represents a deferral of payments for current and prior year costs to future years. Cash flow problems caused the State to withhold \$10.50 billion in payments and interfund transfers from the General Fund as of June 30, 2017 (Illinois 2017, 25). The State's general obligation bonds were rated just a notch above junk bond status: Baa3 with a Negative Outlook by Moody's Investor Services, BBB- with a Negative Outlook by Standard and Poor's, and BBB with a Negative Outlook by Fitch Ratings as of June 30, 2017.

The 2017 CAFR's Management Discussion and Analysis concludes by stating that:

“(t)he State continues to show an inability to generate sufficient cash from its current revenue structure to pay operating expenditures on a timely basis... the accumulated deficit in the General Fund, continued growth in the net pension liability and postemployment benefit costs, and rating downgrades on debt issuances of the State may impact the State's ability to access credit markets to pay operational expenditures more timely and may increase interest costs of those borrowings.” (Illinois 2017, 30)

The State's largest liability arises from its underfunded pension plans. At the end of fiscal year 2017, the net pension liability totaled \$137.67 billion, an increase of 18.7 percent from fiscal year 2016. The net pension liability (pension expense) is not reported as a distinct line item in its government-wide Statement of Net Position (Statement of Activities). Information on these is provided in footnote disclosures.

### **Defined Benefit Pension Plans**

It is common for state and local governments to provide defined benefit pension plans (DB plans or pension plans hereafter) to public employees. A 2014 study showed that approximately 90 percent of employees in the U.S. public sector have defined benefit plans compared with fewer than 30 percent in the private sector. Theoretically, these plans are more efficient than defined contribution plans as they permit pooling of resources and risks across many employees. For example, lower yields from less risky investments by individuals nearing retirement with defined contribution plans do not occur in DB plans since average employee age remains relatively constant over time. Hence, DB plans have the potential to convey greater benefits per dollar contributed to employees who serve governments for significant periods.

DB plans, however, create incentives for governments that often lead to their underfunding. Pension benefits earned are based on actuarial estimates and contributions required to fund them each year are largely discretionary. Since these benefits are paid out many

years in the future, states find it expedient to divert budgeted pension contributions to fund current services. Many voters do not care if pension plans are underfunded since this causes no immediate hardship to anyone, but are very concerned if their current income tax rate is raised to fund pension payments in the distant future. Politicians are often hesitant to risk antagonizing unions who support them with campaign contributions, and their relatively short terms in public office encourage them to use short-term remedies for long-term problems. Consequently, states are more willing to promise higher pensions (which need to be paid only when currently elected officials have left office) than raise salaries of public employees (which consume current resources) in their negotiations with public-sector unions. These incentives do not exist for defined contribution plans for which the requisite annual contributions are specified by contract and must be paid in full each year.

### **Accounting for Public Pensions**

The concept of *interperiod equity* is central to governmental accounting. Many of the balanced budget legal requirements found in governments are based on this concept, which specifies that current citizens should not be able to shift the burden of paying for current-year expenditures to future taxpayers or live off resources raised in the past. Financial reporting should help users in assessing whether an entity raises sufficient revenues to pay for the services provided during the year and furnish information to citizens and their elected representatives that is useful in debates on how these resources should be raised and allocated.

Conceptually, employees earn two types of compensation: salaries and other forms of current compensation that are paid as they work, and pensions and other post-retirement benefits payable after they retire. Hence, pensions are viewed as future payments for services currently performed. Consistent with the concept of interperiod equity, accounting rules require the cost of

pensions earned to be expensed in the year the services are rendered. Pension expense for governments is computed as follows:

“The total pension expense is comprised of the service cost or actuarial present value of projected benefit payments attributed to the valuation year, interest on the total pension liability, plan administrative expenses, current year benefit changes, and other changes in plan fiduciary net position less employee contributions and projected earnings on plan investments. Additionally, the total pension expense includes the annual recognition of outflows and inflows of resources due to pension assets and liabilities.” (Illinois 2017, 62)

The funded ratio – calculated by dividing a pension system’s net assets by the present value of its liabilities – is a measure of the financial condition of a pension system. If system net assets (fiduciary net position) are less than the accrued liability (total pension liability), the difference is called the unfunded liability or net pension liability. Conceptually, with a fully funded system, an employer only needs to contribute its share of the value of benefits earned during the year (known as normal costs) to remain fully funded. With an underfunded system, an employer needs to contribute the additional investment income that would have been earned if the system had been fully funded plus a payment greater than the value of benefits earned during the year to reduce the unfunded liability. Hence, once a large pension system becomes severely underfunded, eliminating the shortfall can be very difficult.

A state’s *government-wide* financial statements (Statement of Net Position and Statement of Activities) report information about the state as a whole and are drawn up on an accrual basis. Therefore, pension expense and net pension liability for the state are recognized in full on these statements. Frequently, they are not reported as separate line items but disclosed in notes to the financial statements. The state’s CAFR must present the combined numbers from the financial statements of pension plans administered by the state in its Statements of Net Fiduciary Position and Changes in Net Fiduciary Position (refer to Illinois 2017, 44–45) as well

as include required supplementary information in schedules on changes in the net pension liability, state and employee contributions, projected investment returns, and discount rates.

Financial statements for *individual pension plans* (Statements of Net Fiduciary Position and Changes in Net Fiduciary Position) report only amounts to be funded from current resources as liabilities and amounts paid from current resources as pension expenditure. Because pension plans report all of their resources (mainly cash and investments) as assets but only current payments as liabilities, even severely underfunded plans typically report a large positive net fiduciary position. Since this amount is designated for pension payments – and is unavailable to the state for other purposes – it does not appear as an asset in the government-wide statements. The government-wide Statement of Net Position recognizes the pension liability not covered by the fiduciary net position of the pension plan as net pension liability. This presentation is reasonable because while the pension fund is responsible for current payments to retirees, the state is responsible for providing resources for the unfunded portion of the total pension liability.

Many voters and politicians find it hard to understand pension accounting – including the long-term effect of under-funding pensions as well as granting benefit enhancements – due to conceptual complexities and the large impact of compounding over very long time periods. Several standards issued by the Governmental Accounting Standards Board (GASB) with the objective of improving pension disclosures have become effective from fiscal year 2014 onward (refer to Exhibit 1). Consequently, the reporting of pensions on governmental financial statements has undergone major changes.

### **Evolution of the Pension Underfunding Problem in Illinois**

The State of Illinois is the primary sponsor for three public employee retirement systems, the General Assembly Retirement System (GARS), the Judges' Retirement System (JRS), and

the State Employees' Retirement System (SERS), all of which administer single-employer defined benefit pension plans. The State also contributes to two other public employee retirement systems, the Teachers' Retirement System (TRS) and the State Universities Retirement System (SURS), which administer cost-sharing multiple-employer defined benefit pension plans.

Illinois does not generate sufficient revenues to fund public services and cover the State's actuarially-required employer contributions to its five pension systems. This ongoing 'structural deficit' has imposed tough fiscal and political choices on elected officials over the years – fully fund pensions and cut services, or skip a portion of the required pension contribution and maintain as many current services as possible. The State legislature and various governors have elected to balance budgets by diverting revenues from making the appropriate employer pension contributions – which does not reduce pension payments to current retirees – to maintaining services like education, healthcare, public safety and caring for the disadvantaged, which benefit current citizens. This has obviated the need to enact tax increases and service cuts or implement a major redesign of the State's financial system, all of which involve making politically difficult decisions. Consequently, the annual contributions to the pension plans have been lower than the benefits paid to retirees in 35 of the past 36 years (Illinois 2017, 62), resulting in a ballooning unfunded pension liability over this period.

Some have argued that the only way to make Illinois' pension systems financially viable in the long term is to cut pension benefits provided to current employees and retirees. Others note that the State's unfunded pension liabilities are not the employees' fault because they have historically paid their fair share of the normal cost of pension benefits through payroll deductions. Further, many accepted lower state salaries against the promise of a specific level

of retirement benefits. Moreover, a majority of public sector workers in Illinois – and in many other states – are ineligible for Social Security, making pensions their only reliable means of retirement income. In view of this, public employees and retirees contend that the State cannot repudiate its pension obligations simply because meeting these obligations presents the State with politically and economically difficult choices.

Against this backdrop, Illinois added the Pension Clause to the State constitution in 1970. The Pension Clause bars the State’s General Assembly from unilaterally reducing the pension benefits of current employees as well as retirees, and forbids increasing employee contribution rates and reducing any benefit increases granted during their terms of employment. While the Clause does not require the State to fund its pension systems at a specific level, it mandates that pensions will be paid in full when they become due. The Clause, according to the Illinois Supreme Court, “was intended to force the funding of pensions indirectly, by putting the state and municipal governments on notice that they are responsible for those benefits.”

Subsequent to 1970, the General Assembly adopted various approaches to funding its pension systems. In fiscal years 1973 through 1981, the State adopted a “100% payout” policy under which employer contributions to the systems equaled 100 percent of the amount paid out in benefits each year, while employee contributions and investment income built a reserve for future payments. As these contributions were well below the State’s actuarial cost of benefits accrued each year, this funding plan resulted in a steady growth in Illinois’ unfunded pension liability. Additionally, legislation was enacted in 1981 that allowed the State pension systems to include risky investments such as mortgage-backed securities in their investment portfolios in order “to reduce the taxpayers’ burden through higher market returns.”

Illinois abandoned even the 100% payout policy in fiscal year 1982 as a budget savings



measure. Instead, the State decided to contribute only 60% of the benefit payments made by its pension systems. Between fiscal years 1982 and 1995, the State's contributions were between 30% and 66% of actuarial cost. The Chicago Tribune reported that the administration "rationed spending on pensions so that scarce state resources could be put toward more pressing and voter-pleasing needs."

Pension benefits were enhanced in 1989 by moving the 3 percent cost-of-living increase for retirees from a non-compounding to compounding basis. This change, which added \$1.3 billion to Illinois' unfunded pension liabilities, was passed with overwhelming majorities in both the State Senate and House without mention of how much this change would cost. Governor James Thompson later remarked that "(i)f anybody had thought that [the cost of the change would exceed \$1 billion] back then, they wouldn't have passed it, or I wouldn't have signed it." Another round of benefit enhancements followed in the late 1990s. Further, between fiscal years 1990 and 1995, over \$1.4 billion in funds earmarked for pensions were reallocated to other budget priorities. By 1994, the unfunded liabilities of the five pension systems had grown to \$17 billion from \$8.2 billion in 1989 and the overall funding percentage dropped from 60% to 54%.

In 1995, Illinois passed legislation intended to "resolve" the impending pension crisis over a 50-year period. This legislation, popularly known as the "Edgar Ramp", included a 15-year phase-in period of increasing pension contributions until fiscal year 2010, after which the State's contributions would remain at a level percentage of payrolls for 35 years to achieve 90% funding in fiscal year 2045. The legislation also gave the State Comptroller's Office the authority to provide funding to the pension systems at the legislated level (the "statutory contribution") without the need for appropriation of funds each year by the General Assembly

(Illinois 2017, 29).

When the plan took effect in 1995, the State's pension systems had almost \$20 billion in unfunded liabilities and a funding ratio of 53%. Due to a booming stock market, the funding ratio improved to 75% in fiscal year 2000. From 2001 to 2003, following the dot-com crash, poor investment returns contributed to an increase in unfunded liabilities, representing \$14 billion of the \$27 billion rise. Another factor was a 2002 plan to provide state workers with an option to speed up their retirements by buying age and service credits needed to qualify for a pension. This plan (originally estimated to cost \$543 million over 10 years) added \$2.3 billion to the pension liability. By 2003, the unfunded liability reached \$43.1 billion, and the funding ratio declined to 49%.

In 2003, Illinois raised \$10 billion through a sale of 30-year general obligation bonds in order to improve the funding position of its pension systems and provide budgetary relief. Of the bond proceeds, \$7.3 billion was deposited in the five retirement systems to increase pension assets, \$2.2 billion went toward the State's contributions to the pension systems for 2003 and 2004 (which would otherwise need to be appropriated from the General Fund), and \$500 million covered the first year's bond interest payments. The bonds paid 5.05 percent interest, and were back-loaded, i.e., payments for these bonds increased over time, from \$500 million in 2005 to \$1.16 billion in 2033. The State's contributions to its retirement systems in 2004 exceeded retirement benefits paid (the only time in the past 36 years), and unfunded pension liability at the end of the year declined to \$35.1 billion. The funding ratio increased to 61 percent. The bond issue permitted diversion of over \$2 billion in pension contributions to cover day-to-day operations of the State – but cost billions of dollars in future bond interest.

In both 2006 and 2007, State contributions were roughly \$1 billion lower than the

amounts required under the 1995 legislation due to “pension holidays.” The holiday legislation was presented in the Senate and House two days before spring adjournment and passed without any actuarial computations on its financial impact. The chief Senate sponsor of the pension-holiday law, Jeff Schoenberg, later said that few of his colleagues “fully understood the cumulative impact of deferring financial obligations into the distant future. ...At the time, it appeared to be a prudent course of action. I can't say that I'd recommend going down that path today.” Poor investment returns caused by the financial crisis, combined with insufficient contributions, increased the unfunded liability from \$42 billion in 2007 to \$86 billion in 2010. Further, the State used proceeds from general obligation bonds to fund portions of its statutory pension contributions in fiscal years 2010 (\$3.45 billion) and 2011 (\$3.68 billion).

The Securities and Exchange Commission (SEC) investigated the pension practices of Illinois during 2005-2009, and accused the State of securities fraud for failing to inform investors of the precarious condition of its pension systems. In a March 2013 cease and desist order, the SEC found that the 1995 plan “increased the unfunded liability, underfunded the State’s pension obligations, and deferred pension funding.” Indeed, in 2006, John Filan, the Director of Governor Blagojevich’s Office of Management and Budget, testified before a subcommittee of the U.S. House of Representatives that the 1995 plan was intended to underfund the pension systems and not pay normal costs and interest on the unfunded liability until 2034, thus assuring steady growth in the unfunded pension liability.

Additionally, the SEC found that the Illinois General Assembly compounded this problem by enacting pension holidays lowering already deficient contribution amounts in 2006 and 2007, and not increasing contributions in 2008 through 2010 to offset these reductions. This underfunding, the SEC noted, “also compromised the creditworthiness of the State and increases

the State's financing costs," and "imposed significant stress....on the State's ability to meet its competing obligations." Taken together, the SEC concluded that because of the State's failure to adhere to the 1995 plan's 15-year ramp period, "the State should have known that it likely would have significant difficulty making required contributions in the future." The State settled fraud charges with the SEC in 2013 for failing to inform bond investors of the risks tied to its statutory funding schedule and impact of the payment holidays.

In 2013, Illinois passed a pension reform bill which – for current employees and retirees reduced cost of living increases, raised retirement ages, limited pensionable salary, lowered employee contributions, set up voluntary 401(k) accounts and guaranteed that the State would make all of its required pension contributions on time in the future. Legislators estimated the reform would save roughly \$160 billion over three decades. In May 2015, the Illinois Supreme Court unanimously overturned the law on the grounds that it violated the Pension Clause of the state constitution since it was enacted without the consent of the state employees it impacted.

In March 2018, the State Commission on Government Forecasting and Accountability (COGFA) detailed the factors that caused the \$110 billion growth in unfunded pension liabilities for Illinois' five state-funded retirement systems between fiscal years 1996 and 2017 (COGFA 2018). COGFA's analysis revealed that 43% of that growth (or \$48 billion) came from shortfalls in the State's payments to the pension systems. Changes in actuarial assumptions, such as people living longer than expected, caused 28% (or \$31 billion). Stock market losses, the next single largest cause, accounted for 13% (or \$14 billion) of the growth. Further, COGFA found that benefit increases for public employees accounted for only 5% (or \$6 billion), while salary increases (which were lower than expected) *reduced* the unfunded

liability by \$5 billion. Based on its analysis, COGFA concluded that Illinois' pension crisis has arisen largely from the State's failure to adequately fund the system.

### **Corrective Measures**

The State of Illinois has additionally implemented the following measures over time with the objective of curbing the rapid growth in its pension liability:

- Less generous pension benefits for employees who started service after January 1, 2011, which include a longer vesting period, higher retirement age, modified pension formula, lower pension cap, lower cost of living increases, and lower spousal benefits. This change was projected to reduce the State's statutory contributions for pensions by an average of over \$1 billion each year over the period 2013-2022.
- The individual income tax rate was raised from 3.75% to 4.95% and corporate income tax rate from 5.25% to 7% effective July 1, 2017.
- The State issued \$6.0 billion in general obligation bonds, to be used solely for the purpose of paying obligations incurred prior to July 1, 2017 (Illinois 2017, 4).
- In its budget for fiscal 2018-19, Illinois offered two plans for pension buyouts to employees hired prior to Jan. 1, 2011. Under one plan, for employees no longer working for the state, the buyout would provide a lump-sum payment of 60 percent of the present value of their vested pension in exchange for leaving the pension system. The state estimated it would get enough state employees to accept the buyout to save \$41 million in fiscal year 2018-19. The second plan was estimated to save Illinois \$382 million in the upcoming budget year. It would give retirees an option to have their cost-of-living increases calculated at 1.5 percent (uncompounded) rather than the current 3 percent compounded annually in exchange for accelerated benefit payments. Illinois planned to issue a maximum of \$1 billion in bonds over three years to fund the lump sum payments. The projected savings under these plans were much lower than the \$160 billion in savings anticipated under the 2013 rules that were later overturned by the Illinois Supreme Court.

### **Concluding Remarks**

An analysis of state government pension funds in the U.S. for 2016 by the Pew Charitable Trust concludes that many state retirement systems are on an unsustainable course even after nine years of economic recovery for the nation (Pew 2018). The funding gap has increased substantially although contributions from state taxpayers nearly doubled as a share of state revenues since 2000, which leaves less money for core government services such as

education, public safety and parks. Colorado, Connecticut, Illinois, Kentucky and New Jersey have the largest pension funding gaps, with Kentucky and New Jersey the most severely underfunded.

A study of U.S. state pensions by Moody's Investors Service reveals that total state adjusted net pension liabilities (ANPL) increased to \$1.6 trillion in fiscal year 2017, which is 147.4 percent of annual state revenues and 8.4 percent of U.S. gross domestic product (Moody's 2018).<sup>1</sup> While there are large variations across states, the median ANPL for fiscal 2017 was 106.8 percent of state revenues. Illinois' adjusted net pension liabilities grew by 25 percent to 601 percent of its revenues in 2017. The State accumulated \$14.6 billion in unpaid bills and was under court orders to pay certain bills, which imposed a strain on other bills as they came due. Susana Mendoza, the State Comptroller, remarked, "I don't know what part of "we are in massive crisis mode" the General Assembly and Governor don't understand. This is not a false alarm. The magic tricks run out after a while, and that's where we're at."

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<sup>1</sup> In order to achieve greater comparability and transparency in its credit analysis, Moody's recalculates state and local net pension liabilities based on a market-determined discount rate and the market value of assets. It generates a measure of pension burden by computing the ratio of ANPL to governmental revenues as reported in each state's CAFR.

## CASE REQUIREMENTS

### **Requirement 1: Role of Accounting**

One reason stated for the increase in Illinois' unfunded pension obligation is that legislators did not understand the full financial impact of granting benefit enhancements (refer to the cost of living increase granted in 1989) and lower than required State pension contributions (refer to the pension holidays granted in 2006 and 2007).

- A. Is deficient financial reporting responsible for this flawed decision-making?
- B. Explain the potential role of accountants in mitigating this problem.
- C. Who is responsible for developing the state's budget? How is the budget voted on and implemented?
- D. Who was the auditor for the state? What audit opinion did the financial statements receive for fiscal years ended June 30, 2015-2019? How does the audit opinion given to this county by its independent auditors differ from the audit opinion rendered on the financial statements for a for-profit business?

### **Requirement 2: Overview of the CAFR**

List one item of information from each of the following sections of Illinois' CAFR for the fiscal year ended June 30, 2019. Briefly explain why each item you list is useful in evaluating the state's financial health. **Provide the page number on which the information appears.**

<https://illinoiscomptroller.gov/financial-data/find-a-report/comprehensive-reporting/comprehensive-annual-financial-report-cafr/>:

- A. Comptroller's Letter
- B. Management's Discussion and Analysis Section
- C. Government-wide Financial Statements
- D. Governmental Funds Financial Statements
- E. Notes to the Financial Statements
- F. Required Supplementary Information other than MD&A
- G. Statistical Section

### **Requirement 3: Analysis of Financial Condition**

- A. Find the **total assets**, **total liabilities**, **net assets**, and **unrestricted net position** for the State from 2015 to 2019. Identify the primary reasons for any observed trends.
- B. For the General Fund, **which assets** and **what amounts** are reported? Overall, did the size of the General Fund balance increase or decrease from 2015 to 2019? By how much?
- C. Compute **cash** (sum of cash equity with state treasurer, cash & cash equivalents, and deposits held by the federal government); **short-term liabilities** (total liabilities minus long-term obligations due subsequent to one year); **current ratio** (cash divided by short-term liabilities); and **long-term financial leverage** (total liabilities divided by total assets) for the State from 2015 to 2019. Highlight the trends for the three measures, comment on the State's ability to meet its short-term financial commitments, and discuss the primary driver of the trend in the long-term financial leverage.
- D. Find the schedule in the Statistical Section of the CAFR that provides details of bonds and other long-term financial obligations. Comment on any changes in the State's ability to repay its long-term debt from 2015 to 2019. Explain how total primary government debt per capita and as a percentage of personal income assist in reaching your conclusion.
- E. A reconciliation should be presented to explain the difference between the net changes in fund balances for the governmental funds (fund-based financial statements) and the change in net assets for the governmental activities (government-wide financial statements). What were several of the largest reasons for the difference from 2015 to 2019?

### **Requirement 4: Resource Inflows and Outflows**

- A. For the primary government, tabulate the **total general revenues**, **total expenses (net of program revenues)**, and **change in net position** using the government-wide Statement of Activities from 2015 to 2019. List the two largest revenue sources and two largest expenses (net of program revenues) reported in the statement per year. Comment on where the State collects its revenues and where it spends its money. Are the State's revenues sufficient to support its spending?
- B. What was the **total expenditures recorded by the General Fund** only during from 2015 to 2019? How were those expenditures classified? How much was specifically spent on public education, higher education, health, welfare, public safety, transportation, unemployment, and interest on debt? If these expenditures are missing on the primary financial statements are they in a separate set of financial statements?
- C. Calculate the **risk ratios** (see bottom) from 2015 to 2019, and report your findings. Discuss the trends and use charts or graphs to illustrate.

### **Requirement 5: Pension Funding**

- A. Refer to the pension/retirement sections. Tabulate the **ratio of pension expense to total governmental activities expenses** from 2015 to 2019. Use total annual pension cost for all the State's retirement systems to approximate pension expenses. Comment on the trend.



- B. Refer to the tables in the pension/retirement and OPEB sections. Show the **fiduciary net position, total pension liability, net pension liability, plan funded percentage, contributions, net pension obligation, net pension liability as a percentage of covered payroll**, and **Other Post-Employment Benefit cost** from 2015 to 2019. Interpret these amounts, and explain how they are related to each other.
- C. The State funded its pension plans at the statutory amounts for the year ended June 30, 2017 (Illinois 2017, Table 16-2, p. 144). However, the contributions to GARS, JRS and SERS were deemed to be deficient in 2017 (Illinois 2017, 192). Explain why the actuarially determined contribution is higher than the statutory contribution.
- D. Explain the impact on the net pension liability of the 1995 plan to “resolve” the pension crisis. Is this plan consistent with the concept of interperiod equity?

**Requirement 6: CAFR Disclosures on SERS Pension Fund**

- A. Refer to the tables in the pension/retirement section for 2019 and look for the reported information about SERS measured on June 30, 2019. Show the **fiduciary net position, total pension liability, net pension liability, plan funded percentage, contributions, net pension obligation**, and **net pension liability as a percentage of covered payroll**. Explain why a large fiduciary net position and net pension liability exist at the same time.
- B. As of June 30, 2019, what is the **long-term expected return on SERS’ plan assets**? What is the **actuarial assumption on the investment rate of return**? What is the **discount rate** used to compute the total pension liability for SERS?

**Requirement 7: Using Proceeds from Bond Issues to Fund Pensions**

The State issued general obligation bonds in 2004, 2010, 2011, and 2017 to fund payments to its pension systems. Refer to Schedule 10 in the Statistical Section for 2017 and comment on:

- A. The impact and desirability of using bond proceeds to make General Fund payments to reduce the net pension liability
- B. The impact and desirability of using bond proceeds to make the statutory annual payments to the state pension funds
- C. The State’s ability to issue additional general obligation bonds to fund its pension systems.

**Requirement 8: Second State:**

Repeat Requirements 3, 4, and 5 (A and B) for your assigned state.

**Requirement 9: State Comparison**

Using the memo format, write a comparative analysis of Illinois and your state incorporating your answers for Requirements 3, 4, 5, and 8. Discuss some of the pre-pandemic fiscal and operational challenges faced by the two states and how has the pandemic worsened the economic conditions for the two states. Support your argument with news stories. **Memo should be limited to two pages, single-spaced with one-inch margins, using 12-point font.**

## **EXHIBIT 1**

### **Evolution of Governmental Accounting Standards for Defined Benefit Plans**

Prior to 2014, the key accounting rules for government pension plans were based on the following GASB pronouncements:

- Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, issued 1994.
- Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, issued 1994.
- Statement No. 50, *Pension Disclosures*, issued 2007.

Under these rules, a government disclosed detailed pension plan information (including actuarial assumptions and assessments) in the notes to the financial statements. Underfunded pension obligations appeared as unfunded actuarial accrued liabilities (UAAL) in the notes to the financial statements but these were not recognized in the financial statements. UAAL was amortized over no more than 30 years and increased the annual required contributions (ARC), the amounts deemed necessary to adequately fund a pension plan. Multiple actuarial cost methods were allowed to determine the present value of a pension obligation and the discount rate was based on an estimated long-term investment yield for the plan.

In 2012, GASB issued Statement 67, *Financial Reporting for Pension Plans* (effective for fiscal years beginning after June 15, 2013) and Statement 68, *Accounting and Financial Reporting for Pensions* (effective for fiscal years beginning after June 14, 2014). The new standards shifted from a funding-based approach to an accrual-based approach and removed the earlier link between how a government funded its pensions and how it accounted for them. GASB states that the new standards “offer an up-to-date indication of the extent to which the total pension liability is covered by the fiduciary net position of the pension plan” (GASB 67, 6) and “improve the decision-usefulness of information in employer and governmental non-employer contributing entity financial reports” (GASB 68, 9). GASB argues that the new standards also improve comparability, transparency, and accountability.

The new accounting standards introduced the following major changes (not an exhaustive list) in the financial reporting of single-employer defined benefit pension plans:

- Recognition of net pension liability. Net pension liability (NPL) was introduced by the new rules and is not the same as UAAL. Unlike UAAL, NPL is recognized as a liability in the government-wide Statement of Net Position. This increases total liabilities and reduces unrestricted net position for governmental entities with underfunded pension plans.
- Plan assets. Pension plan assets are valued at fair value, as opposed to a smoothed value under the earlier rules.
- Revised definition of pension expense. Pension expense is no longer based on the annual required contribution (ARC) adjusted for past under/over contributions by the government. Instead, it now primarily captures the year-to-year change in the total pension liability (with several exceptions).
- A blended discount rate. Previously, pension funds used the long-term expected rate of return on plan assets as the discount rate. Under the new rules, the long-term expected rate of return on pension plan investments is used as the discount rate only for the portion of benefit payments that are expected to be covered by plan assets, and the yield or index rate for 20- year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher is used as the discount rate for the portion not covered by plan assets. Since index rates on municipal bonds are typically lower than expected returns on long-term investments, use of the blended discount rate tends to increase the net pension liability relative to the UAAL (normally by a small amount) disclosed in earlier years.
- Gains and losses. Asset/liability gains and losses for pension funds due to differences between actual and expected returns on plan investments as well as changes in actuarial assumptions are initially recognized as deferred inflows/outflows on the Statement of Net Position, and amortized to pension expense over shorter periods than under the prior pension rules. Deferred outflows and inflows are a new reporting concept introduced by GASB 67 and 68, conceptually similar to accumulated other comprehensive income in the context of corporate pension accounting. They are reported on the Statement of Net Position separately from assets and liabilities.

## Case-Related Video Material

*The Illinois Pension Disaster: What Went Wrong?* <https://www.cityclub-chicago.org/video/1043/the-illinois-pension-disaster-what-went-wrong>

*The Pension Bomb.* <https://www.youtube.com/watch?v=rTX405bUrSo>

*Illinois Pension Obligations.* <https://www.khanacademy.org/humanities/us-government-and-civics/american-civics-parent/american-civics/v/illinois-pension-obligations>

*Illinois Pensions are Completely Broke!* <https://www.youtube.com/watch?v=0CzCOEanyNQ>

*Illinois Pensions Face Problems in Debt Crisis*  
<https://www.cnbc.com/video/2017/06/30/illinois-pensions-face-problems-in-debt-crisis.html>

**Risk Factors of Fiscal Distress and Their Expected Relation with Fiscal Distress**

Indicator	Measure	Expected Relation with Fiscal Distress
Taxes to Revenues (TAXREV)	$\frac{\text{Tax Revenues}}{\text{Total Revenues}}$	+
Inter-governmental Revenues (IGR)	$\frac{\text{Revenues from Federal and State}}{\text{Total Revenues}}$	+
Administrative Cost Ratio (ADMIN)	$\frac{\text{Administrative Expenditures}}{\text{Total Expenditures}}$	-
Debt Level (DEBT)	In (Total Liabilities)	+
Debt to Revenue (DEBTREV)	$\frac{\text{Total Liabilities}}{\text{Total Revenues}}$	+
Size (SIZE)	In (Total Revenues)	-
Revenue Growth (GROWTH)	$\frac{\text{Total Revenues}_t - \text{Total Revenues}_{t-1}}{\text{Total Revenues}_{t-1}}$	-