

July 31, 2009

Transmittal Letter

To: Director of Research and Technical Activities, Project No. 34

We have prepared the following response to the Governmental Accounting Standards Board's Invitation to Comment on Pension Accounting and Financial Reporting. We wish to thank the broad cross section of public sector actuaries whose extensive discussions and contributions provided the substance and the rationale for our positions.

While not every one of the undersigned agrees with every point made, we believe that our response reflects a substantial consensus among actuaries who provide valuation services to public pension systems and so have practical working familiarity and experience with these issues. We would also like to point out that several of the issues addressed in the Invitation to Comment speak to aspects of actuarial practice which the Actuarial Standards Board has left open to professional judgment. We hope that the GASB will preserve the use of professional judgment in the situations that so warrant.

We believe that the changes discussed in our response would result in an improvement over current practice because they retain the sound fundamentals of GASB 25 and 27, while adding certain enhancements which address many of the concerns that we have heard from various users of the financial statements.

We are grateful to the GASB for preparing the Invitation to Comment and inviting public pension actuaries and others to weigh in on this important matter. We would also like to request that Paul Angelo be allowed to speak on our behalf during the public hearing on August 26<sup>th</sup>.

The following signatures were approved by direction.

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## Public Plans Discussion Group - Response to GASB Invitation to Comment (ITC)

The following introduction presents key concepts that provide a framework for our responses to the questions in the ITC.

### Public Pension Plans: Managing Contributions and Benefits

The provision of pension benefits typically involves two fundamentally different cash flows. One is the stream of payments paid out from the pension plan to members and beneficiaries who are eligible to receive benefits. The other is the stream of contributions paid into the plan by the sponsoring employer (on behalf of the taxpayers) as well as by employees. For prefunded pension plans, the contributions for each member are made well in advance of the benefit payouts, developing a corpus of assets which is invested to earn additional income, thereby offsetting future employer (i.e., taxpayer) and member contributions with investment earnings. This approach has worked well for many public plans over much of the last century.

One can think of the stream of benefit payments as representing the “economic value” of the benefits to plan members. Similarly, the stream of employer contributions represents the “economic cost” of the benefits to the employer (and taxpayers). It is important to note that these are two fundamentally different cash flows. Given that the contributions are invested, and that some investment earnings are likely, the cash flows representing the contributions (i.e., the ultimate “economic costs”) will be less than the cash flows representing the economic benefits. Generally, for most pension plans over the long term, this relationship is expressed in the following equation:

$$\text{Contributions} + \text{Investment Income} = \text{Benefits} + \text{Expenses}$$

A pension plan acts as a financial intermediary to manage the relationship between economic cost and economic value. This is done primarily by pooling risks, managing the monies held in trust, and providing a means for incurring the contributions (the economic cost to the taxpayers) during the period of the members’ service, i.e., well in advance of the eventual benefit payout (the economic benefit to the members). This last, crucial function involves establishing and monitoring a funding policy for financing the economic benefits during the period of the members’ service. The funding policy provides the basis for performing actuarial valuations of plan benefits, and involves the following steps:

1. Projecting the future benefit stream using demographic and economic assumptions related to mortality, likelihood of retirement, projected future service and projected future pay, etc.
2. Determining the present value of the projected future benefits by discounting the estimated cash flows using a discount rate that anticipates future investment returns.
3. Allocating the present value of future benefits to each year of service so as to establish a “normal cost,” which is the portion of the ultimate economic cost that is allocated to each year of service. For active members, the accumulated value of the normal costs allocated to years of service to date is then the “actuarial accrued liability” (AAL), which represents the economic cost accrued (allocated) to date. For inactive and retired members the AAL is simply the present value of benefits from step 2.
4. Determining annual employer contributions based on the annual normal cost plus an amount to amortize the unfunded actuarial accrued liability (UAAL) (i.e., the difference between the actuarial accrued liability and the actuarial value of plan assets). By amortizing the UAAL, the valuation

reflects not only the economic cost accrued to date but also the plan assets that have accumulated to fund that accrued cost.

It is also important to note that the stream of normal costs and the related actuarial accrued liability are financial constructs developed so as to determine the appropriate contributions. There are various actuarial “cost methods” that can be used to perform the cost allocation in Step 3, which can produce very different patterns of normal cost accrual. However, the only real cash flows are the contributions that are actually made to the plan and the benefits that are actually paid out. This is true regardless of which actuarial cost method is used.

For the vast majority of state and local plans, the actuarial methods used to finance the plan are intended to: (1) provide an orderly and systematic allocation of contributions over the members’ periods of service, and (2) minimize the volatility in contributions due to short-term investment and other actuarial gains and losses. This is done to not only improve economic efficiency and minimize taxpayer costs but also to match the incurral of cost by the taxpayers with the receipt of services from the plan members. In particular, the contributions are generally calculated as level percent of member payroll, in order to establish contribution rates that remain a level proportion of taxpayer purchasing power over time. This helps to promote both accountability and interperiod equity.

These goals are carried through a variety of actuarial techniques that have been used for decades by public plans:

- The vast majority of public pension plans use the entry age normal actuarial cost method to determine contribution rates as a level percentage of covered payroll over time. This is done by including projected future salary and service in the normal cost. Other actuarial methods also obtain similar efficiencies.
- The long-term expected return on plan investments is used to discount projected future benefits. This helps to stabilize the contribution rates by anticipating actual returns that are expected from plan assets. In other words, use of expected returns means that there’s an even chance that actual investment returns will be greater or less than expected, thereby spreading the advantages (and disadvantages) of taking on investment risk evenly over present and future taxpayers.

The actuarial accrued liability is a point-in-time measure of the stream of normal costs accrued through the actuarial valuation date. As such, it is not in any direct way a measure of the value today of the stream of accrued benefits. There are point-in-time measures of the value of the benefit stream, which vary depending on the extent to which the measure includes projections of future salary and service. As discussed in more detail in our responses to the ITC questions, the accrual patterns of these simple present value measures do not accomplish the objectives of accountability and interperiod equity as well as the level cost accrual methods that are designed with these objectives in mind.

### **Contributions and Accounting Expense**

As discussed later in this response, one of the most important decisions that governmental employers must make is to contribute their annual required contribution (ARC). The current accounting standards do an excellent job of focusing attention on a critical problem area, where employers do not actually contribute the ARC. For that reason, an ARC based on the actual financing requirements is very much decision useful. If accounting standards change to focus on the benefit accrual process, the linkage between funding and accounting may be broken and less attention may be paid to the most decision-useful pieces of information – what contributions are currently required and whether or not the employer is making those contributions.

## Response to ITC Question 1

**Question 1:** *To best achieve the financial reporting objectives of accountability and decision usefulness, including the assessment of interperiod equity, which of the following processes related to pensions do you believe government accounting and financial reporting should provide information about, and why?*

- a. *The process by which an employer incurs an obligation to employees for defined benefits earned by them*
- b. *The process by which an employer finances its projected future cash outflows for defined pension benefits*
- c. *Both processes.*

**We believe that the financial reporting objectives of accountability and decision usefulness, including the assessment of interperiod equity, are best achieved when the focus is on the process by which the employer finances its projected cash outflows for defined benefit plans.**

As discussed in the introduction to this response, state and local governments manage the costs of their DB pension promise by actuarially valuing and prefunding the benefits using level cost methods that anticipate future investment returns. This process is central to managing the financial and budgetary impact of the benefit promises on the government. The usefulness of the measures related to this financing process is evident in Chapter 1, paragraph 15, of the GASB's ITC. Of the seven decisions and judgments related to pensions for which reported financial information is potentially relevant and useful, at least six require measurements based on the process by which the employer finances its projected cash outflows. These decisions and judgments are related to:

- Funding the benefits (15b);
- Evaluating proposed changes to plan terms that would affect the amount of benefits (15c);
- Assessing the funded status and funded progress of the pension plan (15d);
- Assessing the overall economic condition of the employer, the employer's annual operating results, and the cost of government services (15e);
- Assessing the potential future cash flow demands to fund pension benefits (e.g., for the purpose of determining the employer's credit strength) (15f); and,
- Allocating plan assets for investment purposes (15g).

In order for useful decisions to be made in any of these areas, it is important that the actuarial valuation reflect projected benefits on a level cost basis. For example, if proposed changes in plan terms were evaluated only based on salary and service to date, relatively little of the ultimate cost of the benefit changes would be reflected in the valuation. Moreover, if projections of future pension contribution cash flows were based on salary and service to date, those cash flows would be underestimated.<sup>1</sup> In addition, it is important to have accurate estimates of future contribution cash flows in allocating plan assets for investment purposes.

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<sup>1</sup> Note, however, that if credit rating agencies and bond investors found reporting of the cash flows for future benefits useful, we would support the inclusion of projections of those future cash flows in the notes to the financial statements.

In fact, one of the most important decisions that governmental employers must make is to contribute their annual required contribution (ARC). As noted in our introduction, the current accounting standards do an excellent job of focusing attention on situations where the ARC is not being contributed, and hence are very decision useful. If accounting standards change to focus on the benefit accrual process, the linkage between funding and accounting may be broken and less attention may be paid to the most decision-useful pieces of information – what contributions are currently required and whether or not the employer is making those contributions.

With regard to interperiod equity, we believe this is best achieved through the use of an actuarial cost method that reflects projected future salary and service and that incorporates a stable, level cost pattern over the members' careers. As discussed below, measures based merely on the obligation incurred for accrued benefits to date are neither level nor stable. To allocate the costs of benefits, we believe that charging different generations of taxpayers what is expected to be the same percentage of pay for a particular worker's pension benefit is the most likely means to achieve interperiod equity. We further believe that these costs should reflect the actuary's best estimate of all future experience, including future salary growth, anticipated termination dates, longevity, and anticipated investment return.

With respect to assessing the funded status, we believe the appropriate technique is to measure funded status based on how much of the employer's projected obligation has been funded under the financing process.

With respect to assessment of an employer's economic condition and annual operating costs, we believe the financing approach is the appropriate measure. The financing measure focuses on the employer's contributions rather than the individual employee's benefit accrual. A key role of the pension plan is to manage the contribution requirement so that the employees benefit accrual has no direct impact on the economic health or operating cost of an employer<sup>2</sup>.

With respect to asset allocation, what matters are the actual cash flows related to an employer's contributions to the pension fund, not theoretical amounts related to an employee's accrual of benefits. This asset allocation practice will enhance actual returns by tying assets to the actual pattern of cash flow, rather than to a hypothetical liability.

**While we believe the process by which an employer incurs an obligation is important, we are concerned that the meaning and implications of selecting answer "a" in Question 1 are unclear. If selecting "a" means agreeing that the long-term costs of providing promised benefits should be reported, we agree and believe that measures based on traditional actuarial cost methods are useful for this purpose. If selecting "a" means agreeing that a separate actuarial approach should be used to determine a pension cost and obligation based only on accrued benefits for service to date, we disagree, believing such information is not decision useful, violates interperiod equity, and would at best be confusing and at worst misleading and prone to misuse.**

If pension benefits were funded based only on salary and service to date, the contributions would increase as a percentage of salary over time, costing governments more as participants accumulated service and drew closer to retirement. This increasing funding pattern is one of the reasons this approach is not used

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<sup>2</sup> For example, consider an employee who turns 55 and becomes eligible for an early retirement benefit. An employer focused on the financing approach would have pre-financed the cost of this anticipated increased benefit and recognize the economic cost of this benefit over the employee's career to date. An employer focused solely on the benefit accrual would suddenly recognize deterioration in its economic health despite knowing for years that this employee would eventually turn 55.

for funding by public or private plans. For the most part, this method is appropriate only as a settlement measure in the event of a plan termination or an employer withdrawal.

For accounting purposes, the incurrence of accrued benefits approach has been suggested as a means of valuing the pension benefits earned to date in a way that is consistent with the measure of current salaries. Consequently, by implication, it is suggested to be useful in collective bargaining situations as a way of pricing the value of changes in pension benefits in relation to changes in salaries. However, by excluding projected salary and service, such a measure would not properly reflect the employer's long-term cost of the benefit changes.<sup>3</sup>

Moreover, these accrued benefit based methods result in pension costs that are especially sensitive to eligibility conditions. For example, normal costs measured under the accrued benefit methods (i.e., the unit credit and projected unit credit methods) spike sharply when a member becomes eligible for unreduced benefits and then decline sharply thereafter or even become negative. It is difficult to see how this kind of short term volatility would assist in making useful decisions.

**We also believe that focusing on both financing and the incurrence of benefit accrual would be confusing and potentially misleading and subject to misuse. We agree with the GASB's Statement 27 decision that "consistency in the measurement and disclosure of pension information ... will enhance the understandability and usefulness of pension information to users of governmental financial reports."<sup>4</sup>**

If both the financing and benefit accrual focuses were used, we assume that an actuarial level cost method reflecting projected salary and service (e.g., the entry age normal (EAN) method) would be used to determine the annual contributions and funded status of the plan. In addition, an accrued benefit method (either traditional unit credit [UC] or projected unit credit [PUC]) would be used to measure of the obligation incurred for benefits accrued by employees. Even if these measures were calculated using the same assumptions, the costs and liabilities associated with the two methods would be different. Since governments are inherently political, this difference would likely spark controversy as to which was the correct or "true" measure of plan costs and liabilities. This could lead to misuse of information as each party chooses the measure which meets its specific political objective.

Moreover, if the "market value liability" (MVL) approach were used to measure the value of accrued benefit, the differences between the two approaches could be extreme. Under the MVL approach, the UC method is used in combination with a discount rate based on risk-free bond yields. Consequently, the liability under the MVL approach would change as market yields change. As a result, you could have situations where the EAN actuarial accrued liability and the MVL accrued obligation not only differed by billions of dollars but did so in an unpredictable and volatile fashion. This is discussed in more detail in our response to Question 5, below.

**We also believe there are other related issues that would be useful to address:**

- **Accrual Patterns Not Defined/Benefits Not Accrued Over Time:** Any method that focuses on the process by which an employer incurs an obligation for accrued benefits must deal with benefits where the accrual pattern is not defined and with benefits which do not accrue over time. This includes disability benefits, since they do not accrue over time, as well as some retirement and other postemployment benefits. For disability benefits, focusing on when the benefit is accrued would lead one to allocate the whole cost of the benefit to the year in which the member became

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<sup>3</sup> A simple example of this is the inclusion of longevity pay in a pension calculation. Longevity pay occurs late in an employee's career and would drive up benefit costs years after the improvement is granted.

<sup>4</sup> GASB Statement 27, paragraph 63.

disabled. We believe this result would be a gross violation of interperiod equity. Such a problem is also obvious in the case of post-retirement healthcare benefits which in very many cases also do not accrue over time. Although beyond the scope of this ITC, application of an accrual method to retiree health benefits is even more problematic and artificial.

- **Members Share in Financing:** Most pensions in the public sector have some member contributions – essentially resulting in a sharing of costs between the employer and members. As such, the employer’s obligation to sacrifice future resources is related to both the benefits that are promised and the method whereby the cost of those benefits are shared between the employer and the members. It is especially important that the members’ cost be level and stable, to avoid undue burdens on the members as they age and become eligible for benefits. This further argues for level and stable employer costs, so there is a consistent cost sharing relationship over the members’ careers.

For all of the above reasons, we feel that focusing accounting on the process by which an employer finances its projected future cash outflows for defined pension benefits rather than the process by which an employer incurs an obligation for benefits accrued by employees for defined pension benefits would result in greater accountability and decision usefulness. We also feel that the additional value of disclosing information on both processes is uninformative, potentially confusing to the reader of the financial statements, and subject to misinterpretation or misuse.

## Response to ITC Question 2

**Question2:** *What obligations of a sole or agent employer associated with pensions meet the definition of a liability in Concepts Statement No. 4, Elements of Financial Statements, and why?*

- A measure of the cumulative difference between (1) amounts expensed, based on annual required contributions of the employer to the pension plan pursuant to a program of funding pension benefits developed within established parameters, and (2) the amounts the employer actually has contributed to the plan*
- A measure of the employer’s unfunded accrued benefit obligation to employees at the financial report date related to the employment agreement governing the exchange of employee services for salaries and benefits*
- Other.*

**We believe the approach followed in Statement 27, which emphasizes the accounting and financial reporting for pension expense based on a sole or agent employer’s annual required contributions under an actuarial funding program is the best basis for determining the employer’s pension expense and liability, provided it is based on reasonable assumptions and methods.**

As provided in Concepts Statement 4, liabilities are “present obligations to sacrifice resources that the government has little or no discretion to avoid.”<sup>5</sup> This obligation represents a “social, legal, or moral requirement, such as a duty or a contract, or promise that compels one to follow or avoid a particular course of action.”<sup>6</sup>

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<sup>5</sup> GASB Concepts Statement 4, paragraph 17.

<sup>6</sup> GASB Concepts Statement 4, paragraph 18.

There are many measures of liability which meet this definition. The distinguishing feature among the different liabilities is their immediacy and their reliability. The NPO, which is a measure of a cumulative difference between contributions required and contributions made, is the most immediate (and reliable) liability measure. Other liabilities include an accumulated benefit obligation (ABO), a projected benefit obligation (PBO) and even the present value of future benefits (PVFB). All four of these liabilities meet the Concept 4 definition to a greater or lesser degree.

The cumulative difference between the employer's pension expense based on actuarially required contributions and the employer's actual contributions (also referred to as the "net pension obligation" or NPO) meets the Concepts Statement 4 definition of liability in the following ways:

- The NPO is a present obligation to sacrifice resources. The annual required contributions and amortized unfunded liabilities represent the current cost of funding the promised benefits. To the extent this cost is not paid, there is a liability. This approach is essentially identical to the expense/liability construct provided for cost-sharing multiple-employer pension plans, whereby the failure to pay a contractually required contribution (an expense) results in a liability for the unpaid contributions.
- The NPO is an obligation that the government has little or no discretion to avoid. The ARC is the best estimate of the annual contribution required to support the promised benefits. To the extent the employer does not pay the full ARC, it is appropriate that the related liability is reflected in the employer's government-wide financial statements with interest.
- The NPO represents a social, legal, or moral requirement that compels the government to follow a particular course of action. This course of action is to fund the benefits.

The NPO has other advantages as well. Characterizing the liability as the difference between required and actual contributions is easy to understand and the accumulated difference between the ARC and actual contributions is easily verifiable. This makes the measure useful in terms of accountability since it provides a clear answer to the question of whether the government has been making its actuarially required contributions.

**We believe one of the greatest advantages of using the NPO is the link between funding and accounting.**

Unlike the private sector, which has minimum contribution requirements specified through the Internal Revenue Code, public plans have frequently used their expensing requirements as a proxy for their funding. This has helped to promote the core values expressed in the Concepts Statements, i.e., accountability, interperiod equity and decision usefulness. To move to a method other than NPO is to risk breaking that link between accounting and funding and with it failing to meet those core values.

**We believe the public sector retirement funds exhibit features not seen in the private sector; that public sector funds are not as "comparable" to each other as their counterparts in the private sector.**

Public sector funds are governed by local law, not by one single federal law. Thus, some plans may guarantee only accrued benefits, while others may have contract rights that protect all future (unearned) benefits for active members. To attempt to compare plans by placing the ABO or PBO on a balance sheet is

to mislead the entire audience of financial statement users, for the unavoidable liability of one plan may not be the same as another's. Plan structures also prohibit comparability; for example, cost sharing systems have no individual liability and thus would not even have an amount that could be shown on their balance sheet. Since plans are not comparable, we feel their "unfunded accrued liabilities" (i.e., unfunded accrued benefit obligations) should be disclosed rather than placed on their balance sheets.

**We also believe the unfunded accrued benefit obligation would not be the best basis for determining the employer's pension liability.**

The ITC defines "unfunded accrued benefit obligation" as the "unfunded portion of the employer's obligation for pension benefits attributable to past periods of service."<sup>7</sup> In past discussions of this question, the GASB has not concluded that employers should recognize unfunded accrued benefit obligations as employer liabilities. In discussions related to Statements 25 and 27, the Board did not reach a definitive answer to this question, and so did not require it to be used as the employer's pension liability. In the discussions related to Statements 43 and 45, the Board concluded that while the unfunded accrued benefit obligation "does meet certain characteristics of a liability of sole or agent employers," Statement 45 "should not require the employer to recognize the entire unfunded accrued benefit obligation as a liability" for a number of reasons. These reasons relate to:

- the long-term funding approach taken by governments;
- the emphasis on cost allocation for expense recognition purposes; and
- concern about the volatility resulting from short-term fluctuations.<sup>8</sup>

While the unfunded accrued benefit obligation appears to meet the definition of liability presented in Concepts Statement 4, we believe it would not be a reliable enough measure to meet the requirements of Concepts Statement 3. This Statement draws a distinction between "recognition" of an item in the financial statements, and "disclosure" of an item in the notes to the financial statements. As discussed in Concepts Statement 3, "items recognized in a financial statement are intended to provide reliable representations of the effects of the transactions and other events..."<sup>9</sup>

However, unlike measures that relate to events that have happened in the past or present, the measure of the unfunded accrued benefit obligation is based on assumptions about what might happen in the future, and are uncertain as a result. As discussed in Statement 27, this uncertainty includes: "the number of employees who will retire, their retirement dates, and the number of years they or their survivors will receive benefits." Statement 27 goes on to say: "The total cost of pension benefits cannot be known with certainty, either for an individual employee or for plan members as a whole, until the last payment is made."<sup>10</sup> This is not the fault of the methodology or the actuary, but rather a result of the future's inherent uncertainty.

Consequently, if the unfunded accrued benefit obligation were used as the employer's measure of pension liability, it would very likely be subject to sudden changes due to the differences between the plan's experience and actuarial assumptions. While these changes currently are amortized into the measures of pension expense and liability under present accounting standards, they would be immediately recognized on the employer's balance sheet if the unfunded accrued benefit obligation were used as the measure of

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<sup>7</sup> GASB Invitation to Comment, p. 14.

<sup>8</sup> GASB Invitation to Comment, p. 15.

<sup>9</sup> GASB Concepts Statement 3, paragraph 34.

<sup>10</sup> GASB Statement 27, paragraph 69.

liability. This would likely produce considerable volatility on the employer's balance sheet, especially in times of economic decline, leading to even greater fiscal pressure on governments.

### Response to ITC Question 3

**Question 3:** Which of the following expense recognition patterns is more consistent with the concept, in paragraph 27 of Concepts Statement 4, that applicability to a reporting period or periods for purposes of expense recognition in government-wide, proprietary fund, and fiduciary fund financial statements should be determined based on the notion of interperiod equity, and why?

- a. Recognition of the effects of transactions and other events that affect the unfunded accrued benefit obligation as they occur each year
- b. Deferred recognition (deferral and amortization) of some or all components of pension cost other than normal cost over a number of future years determined by an employer or by plan trustees within accounting parameters.

**We believe the deferred recognition of some or all components of the pension cost (other than normal cost) is more consistent with the concept of interperiod equity, provided the overall annual pension costs are, to the greatest extent possible, calculated to remain a level percent of covered payroll over time.<sup>11</sup>**

As discussed in the GASB ITC, a key objective of financial reporting is to determine whether interperiod equity has been achieved. Under Concepts Statement 4, interperiod equity is achieved when "... the burden of the cost of [current period] services is borne by present-year taxpayers and revenue providers" rather than shifted to future-year taxpayers or paid through future borrowing. However, Concepts Statement 4 also emphasizes that interperiod equity is not "a goal that is expected to be met for any particular point in time" but rather a "relevant metric to assess accountability."<sup>12</sup>

Realistically, it is impossible to exactly allocate the costs of future pension benefit payments to the year in which they were earned. To do so, we would have to know the future. The best that can be done is to estimate the costs using realistic assumptions and methods and then to adjust the costs over time as circumstances change. This understanding is reflected in the statement that interperiod equity is "not expected to be met for any particular point in time." For example, should the cohort of taxpayers in 2008 be expected to make up for the entire market losses that occurred in 2008? This is an extreme example of the reason why deferred recognition makes sense when combining the need for interperiod equity with the volatility that can occur within short spans of time.

In our opinion, the best approximation of interperiod equity is met when pension costs are determined using actuarial cost methods that calculate normal costs as a level percentage of payroll using long-term expected rates of return and the unfunded actuarial accrued liability is amortized as a level percentage of payroll. This approach has the highest likelihood of spreading pension costs over time as a level percentage of taxpayers' purchasing power.

**We do not believe the immediate recognition of events that affect the unfunded accrued benefit obligation as they occur each year would necessarily satisfy the concept of interperiod equity.**

Different actuarial cost methods result in different benefit cost accrual patterns. For example, the unit credit method calculates accrued benefits based on accumulated service and current salary, and excludes

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<sup>11</sup> This is not to suggest an unreasonably long period of time. Amortization periods are discussed later.

<sup>12</sup> GASB Concepts Statement 4, paragraph 27.

projections of future service and salary. Consequently, under the unit credit method, the costs of pension benefits for any individual increase each year as the individual's salary and service increase.

Some would argue that this approach is consistent with intergenerational equity on the grounds that it allocates the pension cost of the individual's current period service to current taxpayers. However, when viewed from the perspective of the benefits ultimately paid to the individual when he or she retires, the costs of the individual's benefits have been shifted from earlier taxpayers to later taxpayers. Consequently, the application of this method for funding the benefits would have undermined interperiod equity. Moreover, some benefits (such as disability benefits) have no obvious accrual pattern.

In addition, some events that affect the unfunded accrued benefit obligation are unrelated to the cost of benefits resulting from current period services. For example, actuarial gains and losses, including investment gains and losses, are not related to the services performed by employees in the current period. To immediately recognize them in the current period would result in current taxpayers being overcharged for current services. However, this is less likely to happen under the deferral approach. Finally, since actuarial accrued liabilities are not determined for individual employers in cost-sharing plans, the "immediate recognition" approach would not be appropriate for cost sharing systems.

**We do support the notion of additional disclosure of the changes in the Unfunded Actuarial Accrued Liability (UAAL).**

Although we do not believe that the UABO, UPBO, or UAAL belong on a balance sheet, we do concur that financial reporting would be enhanced if the changes in the unfunded liability from year to year were disclosed in the notes to the financial statements. The following table presents what we believe would be key items to include in the reconciliation of changes in the UAAL.

<b>Reconciliation of UAAL</b>	
Prior Year-End UAAL	
Calculation of Expected UAAL	
Normal Cost	
Expected Contributions (Current Year ARC)	
Expected Interest	
Subtotal: Expected UAAL (on Expected Contributions)	
Contribution Gain/Loss (adjusted to Year-End)	
Subtotal: Expected UAAL (on Actual Contributions)	
Changes Due to Experience Gains and Losses	
Investment Gain/Loss (AVA Basis)	
Other Gain/Loss	
Salary Increases	
Other Demographic Gain/Loss	
Total Experience Gain/Loss	
Other Changes	
Assumption Changes	
Assumed Earnings Rate	
Other Assumptions	
Method Changes	
Plan Amendments	
Total Other Changes	
Current Year-End UAAL	

In addition, there are other items, not addressed in the ITC, which may be useful for public pension disclosure purposes. We would be willing to discuss these with the Board at its request.

#### **Response to IRC Question 4**

**Question 4:** *Should the projection of pension benefits include or exclude the following projected future changes? Why?*

- a. *Automatic COLAs*
- b. *Projected future ad hoc COLAs, in circumstances in which ad hoc COLAs are substantively a part of the employment agreement, as demonstrated by an employer's pattern of practice*
- c. *Projected future salary increases*
- d. *Projected future service credits.*

**We believe the projection of pension benefits should include automatic COLAs and projected future salary increases. Projected future service credits should be included for eligibility purposes. They should also be included in any projection of the future benefit stream as part of a level cost actuarial cost method used to fund the plan. The inclusion of future ad hoc COLAs would depend on the past history of such increases as well as the likelihood they would occur in the future. However, the very uncertainty of those future ad hoc payments would argue for excluding them.**

With regard to automatic COLAs, we believe that as long as the automatic COLA benefit is part of the stated or legal benefit obligation, it should be included in the projection of pension benefits.

With regard to projected future ad hoc COLAs, we believe this may be a situation similar to health benefit provisions appearing to be a substantive part of the plan under GASB 43/45. If so, future ad hoc COLAs could be included in the projection of pension benefits for expense purposes. However, we also believe that determining if an ad hoc COLA is a substantive part of the plan can be very subjective. Some deterministic test may need to be defined as to when an occasional benefit increase becomes a substantial part of the plan.

Moreover, many ad hoc COLAs are payable only when specific conditions arise, and can also be conditional on either the employer or the trustees' specific approval (i.e., in addition to the occurrence of the conditional event). Issues to consider include:

- Many ad hoc COLAs are dependent on the "excess earnings" of the investment return on assets. Under current actuarial valuation procedures, a single level discount rate is used to project future benefit payments. Thus, the conditions that give rise to the conditional ad hoc COLA benefits are dependent on actual experience and would not be expected at all under the valuation assumptions. This could make it very difficult to determine the level of future ad hoc COLAs to include in the projection of benefits.
- If ad hoc COLAs are based on expected investment return, a stochastic projection may be able to measure the probability of an event arising that would lead to an ad hoc COLA. But the pattern of ad hoc COLA increases that are dependent on investment returns may best be recognized by the actuary in determining the net discount rate to use in valuing the base benefits. This may come under consideration when the ASB reviews the current ASOP 27 requirements.

- Note that if such benefits are not considered part of the stated or legal benefit obligation, it may be difficult for some plans to legally prefund for these benefit increases.
- Note also that some ad hoc COLAs are promised (or in the statutory provisions) but are based on certain funding conditions such as when the Funded Ratio exceeds 100%. It would be difficult to predict with any degree of certainty when this type of ad hoc COLA benefit would become payable. Similar difficulties apply to ad hoc COLAs based on investment returns.
- If ad hoc COLA benefits are included in the projection of benefits for accounting purposes, there may be pressure to make them automatic. Thus, including them in the accounting expense could give them more permanence than the employer intended.

With regard to projected future salary increases, we believe these should be included, but that inclusion would also depend on both the focus of the financial reporting and the cost method adopted by GASB as discussed in Chapters 2 and 3. If the financial reporting focus is determined to be the process by which the benefits are financed then absolutely the salary increases should be projected. Even if a unit credit cost method is used to determine the incurrence of the benefit accrual for the year, interperiod equity would argue for some recognition of projected salary increases for a plan that uses a final average salary in determining the ultimate benefit payment.

With regard to projected future service, we believe that it should be included in recognizing future eligibility for certain plan features, regardless of whether the financial reporting focus is on the financing process or the benefit accrual process. It should also be included in the projection of benefits that is the first step of the financing process when using a level cost allocation method.

#### **Response to ITC Question 5**

**Question 5:** *What should be the basis for determining the discount rate used for discounting projected pension benefits to their present value for accounting purposes? Why?*

- a. *The estimated long-term investment yield for the plan*
- b. *A risk-free rate (or a yield curve of risk-free rates applied to cash flows of different maturities)*
- c. *The employer's borrowing rate*
- d. *An average return on high-quality municipal bonds*
- e. *Other.*

**We believe the estimated long-term investment yield is the appropriate rate for discounting projected pension benefits to their present value for public pension accounting purposes.**

For pension benefits, the discount rate is used to determine the effect of expected future investment earnings on plan contributions. As such, it is appropriate to base the expected future investment earnings on the risk and returns associated with the portfolio's actual investment mix. Although actual returns will likely be higher or lower than the expected return in any given year, given the law of large numbers, there is a high likelihood that over the long-term, actual returns will approximate expected returns.<sup>13</sup>

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<sup>13</sup> Milevsky, Moshe A. *The Calculus of Retirement Income*. Cambridge University Press, 2006, p. 87. "So states the law of large numbers ... the arithmetic average of these possible returns would also equal the expected return."

The use of the long-term expected return is supported by the Actuarial Standards Board (ASB), which is responsible for establishing rules related to actuarial practice. In Actuarial Standard of Practice (ASOP) No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*, the ASB states: “Generally, the appropriate discount rate is the same as the investment return assumption.”<sup>14</sup> While discount rates selected independently of the plan’s return assumption are viewed as appropriate for certain purposes, ASOP 27 supports the use of discount rates based on expected investment returns.

The GASB also supports use of the expected long-term rate, and has done so for decades. In GASB Statement 27, the GASB states the “investment return (discount) rate commonly selected for governmental pension plan calculations is based on an estimated long-term rate of return on current and expected future plan investments. The Board believes that rate is consistent with the long-term nature of governmental pension plans and should be required for governmental accounting for pensions.”<sup>15</sup>

Moreover, in Statement 27, the GASB “considered but rejected” the possibility of requiring a specific investment return rate (for example, the expected return on long-term government bonds). Instead, the Board found that the “investment return assumptions selected for a particular plan should be best estimates at the actuarial valuation date of that plan’s earnings on current and expected future investments.”<sup>16</sup>

The expected return also offers the best way to stabilize employer contribution rates over the long-term. This is especially useful for decisions related to budgeting pension costs, since it makes the costs more predictable from year to year. In addition, use of the expected return also helps to satisfy interperiod equity, since it allocates investment risk on an approximately level basis to taxpayers in each period.

**We do not believe the risk-free rate (or similar yield curve) would be an appropriate discount rate for public pension accounting purposes.**

We understand the term “risk-free rate” to refer to the current annual yield (or yield curve) of U.S. Treasury securities (or similar derivative securities) as of the valuation date. We believe that if this rate were used, it would introduce significant volatility in the measurement of public pension costs and liabilities. This volatility would have little to do with the underlying dynamics of the plan and would likely obscure all other factors affecting pension costs. Use of this rate could result in measures of pension costs and liabilities that change significantly, even in the absence of changes to the promised benefits.

The potential impact of using these rates was recently examined in a paper presented at the Society of Actuaries 2009 Public Pension Finance Symposium. The paper compares the public pension funding patterns that result from a conventional actuarial approach with those that result from the “market value of liability” (MVL) approach – which uses the risk-free rate as its discount rate. The paper found that, over the last three decades, annual yields on 30-year U.S. Treasury securities ranged from a high of 13.4% in 1985 to 4.4% in 2003. When risk-free rates were high (e.g., 13.4%), the annual required contribution (ARC) using the risk-free rate would have been low compared to the ARC using expected return (i.e., 2.8% of payroll vs. 8.8%). When risk free rates were low (e.g., 4.4% in 2003), the ARC using the risk-free rate would have been high compared to the ARC using expected return (39.8% of payroll vs. 11.2%).<sup>17</sup>

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<sup>14</sup> ASOP No. 27, Revised Edition, September 2007, section 3.6.

<sup>15</sup> GASB Statement 27, paragraph 91.

<sup>16</sup> GASB Statement 27, paragraph 92.

<sup>17</sup> Jones, Norman L., Brian M. Murphy, and Paul Zorn, *Actuarial Methods and Public Pension Funding Objectives: An Empirical Examination*, presented at the Society of Actuaries Public Pension Finance Symposium, May 2009.

The volatility in contribution rates that results from using the risk-free rate would likely violate interperiod equity, since it would cause taxpayers to pay higher or lower pension costs from period to period solely due to changes in the risk-free rate. Moreover, the volatility would obscure the effect of benefit improvements on employer costs and so would not provide information that would be useful in making benefit decisions.

Finally, from a practical perspective, it should be noted that for 2003 (and other years as well) the paper referenced above estimated an ARC using the risk-free rate that would have been almost four times higher than an ARC using expected returns. This demonstrates that changes to the current standards requiring the use of the risk-free rate would have a substantial impact on employer's sponsoring public pension plans. Consequently, special care should be taken to understand the implications of such a change before any decision is made.

**We also do not believe the employer's borrowing rate or the average return on high-quality municipal bonds would be appropriate discount rates for public pension accounting purposes.**

Pension costs and liabilities are inversely related to the discount rate. Consequently, an increase in the employer's borrowing rate due to a downgrade in credit quality would have the unintended consequence of lowering the employer's pension costs and liabilities. Since pension costs and liabilities are unrelated to the employer's borrowing rate, this change would be misleading.

In addition, use of rates based on the average return on high-quality municipal bonds would introduce problems similar to the use of the risk-free rate. While the average taxable municipal bond rate would be somewhat higher than Treasury rates of similar maturity, it would be just as volatile. Moreover, the volatility would be disconnected from the underlying dynamics of the plan.

For example, since 1979, the interest rates on the Bond Buyer's GO 20-Bond Municipal Bond Index of tax-exempt bonds ranged from a high of 13.28% in January 1982 to a low of 4.11% in December 2006.<sup>18</sup> Assuming marginal tax rates of 28%, this would mean an equivalent taxable yield between 18.44% (=  $13.28\% / .72$ ) and 5.71% (=  $4.11\% / .72$ ). Generally, this series follows a similar pattern as U.S. Treasury securities and would introduce similar volatility to pension costs and liabilities.

The choice between a discount rate based on expected returns and a discount rate based on risk-free returns (or municipal bond yields) is a choice between discount rates that are used for fundamentally different purposes. A discount rate based on expected returns is used to reflect the likely offset to the employer's pension cost that results from future investment earnings. A discount rate based on bond yields reflects how much a borrower must pay a lender to compensate for the borrower's risk of default.

Give that the purpose of a pension plan is primarily to fund the benefit obligation, the discount rate based on expected returns provides the most decision useful information. Present values based on the plan's expected investment returns will better measure the contributions that, together with future investment earnings, are needed to fund the plan over the long term. The estimate of investment earnings is directly useful in determining plan cost. However, discount rates based on risk-free returns and municipal bond yields are not at all useful in determining future investment earnings (unless the plan is entirely invested in such securities). Moreover, because risk-free returns and municipal bond yields are usually lower and more volatile than expected returns, using them would result in taxpayers incurring widely varying costs over different periods and so would violate interperiod equity.

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<sup>18</sup> Board of Governors of the Federal Reserve, Federal Reserve Statistical Release, Selected Interest Rates (H15), various years.

## Response to ITC Question 6

**Question 6:** *If, after due process, the accounting measurement approach adopted by the Board for pensions were to be one of those discussed in Chapter 4 that includes the amortization of some components of pension cost for purposes of recognition of an employer's pension expense:*

- a. *Which actuarial cost method or methods should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?*

**We believe that the six actuarial cost methods currently permitted for determining the employer's annual required contributions (i.e., the ARC and pension expense) are reasonable and appropriate. However, in the interest of enhanced comparability, we find it would be reasonable to limit the actuarial cost methods allowed for determining the employer's pension obligation and expense to four methods: entry age normal, projected unit credit, aggregate and frozen entry age.** Although there is nothing inherently wrong with the attained age and frozen attained age methods, such methods are rarely used and could be eliminated in the interest of somewhat improved comparability.

For purposes of disclosing the accrued liability and unfunded liability in the notes to the financial statements and RSI (hereafter "note disclosures"), we support the required use of the entry age normal method when the aggregate method is used to determine the ARC, as provided in GASB Statement 50. In addition, we would extend this requirement to the frozen entry age method since, like the aggregate, it does not regularly determine an accrued liability.

The reasons we favor continuing to permit the four methods for purposes of determining the ARC are:

- 1) The vast majority of systems currently use one of these four methods for determining both funding and expense requirements;
- 2) Allowing these methods for accounting and financial reporting would maintain consistency between financial reporting and the funding policies adopted by the individual plans;
- 3) Although mandating a single method might give the appearance of comparability, the appearance would be misleading, especially if different methods continued to be used for funding.

Most actuaries favor entry age normal for a variety of reasons, including its desirable feature of allocating costs as a constant percentage of payroll over an employee's career. Because of this, any proposed methods for determining the ARC should include entry age as an acceptable method. In order to maximize decision usefulness, entry age should also be the default method for note disclosures when the aggregate and frozen entry age methods are used to determine the ARC, since these methods do not determine an accrued liability.

In situations where the projected unit credit (PUC) is used to determine the ARC, we also favor its use for note disclosures, for the following reasons:

- 1) If the PUC method is used for financial reporting then the employer's pension obligation and expense are based on the allocation of cost to past and future years as determined under that method. Note disclosures that reflect that same allocation will be more decision useful in assessing both current costs and the relationship of plan assets to accrued obligations.

- 2) As long as the method is one that determines an accrued liability, it will be less confusing to the user of the note disclosures if the same method is used for note disclosures as is used for financial reporting;
- 3) Using the same method for note disclosures as for financial reporting will avoid any inference that the pension obligation and expense are being determined in a way that is suspect or inappropriate.

**However, we strongly believe that to determine the employer's pension obligation or expense, or for the purpose of note disclosures, the unit credit method should not be used for pay related plans. Under this method, the pension obligation is simply the present value of accrued benefits, based on current service and pay. While it might be an appropriate method for non-pay related plans or for cash balance plans, we do not believe it is appropriate for pay related plans, and therefore not appropriate for most public pension plans, for the following reasons:**

- 1) The unit credit method has an extraordinarily back loaded cost accrual pattern, and so does not reflect a meaningful portion of pension cost until late in an employee's career;
- 2) It focuses narrowly on the value of benefits actually accrued by individual employees, whereas the function of accounting and financial reporting (as well as funding) is to focus on the employer's pension cost appropriately allocated over the employees' careers;
- 3) It does not allow for systematic recognition of benefits which are nearly certain to be paid out, such as benefits based on future compensation, or benefits that reflect meeting future eligibility requirements based on age and service. In most cases, these benefit levels are very predictable;
- 4) Because the unit credit method is so easy to understand, it can mislead users into believing that it conveys decision-useful information for determining the level cost and funded status of the plan;
- 5) It can provide useful information in the case of a plan which may terminate, in which case plan obligations usually (but not always) convert to the unit credit liability. While common in the private sector, plan terminations are rare in the public sector because:
  - a. Benefit accruals often cannot be simply ceased as under ERISA,
  - b. Public entities and public pension plans rarely cease to exist,
  - c. Public entities rarely sell off divisions of employees and their benefit obligations as do businesses.

*b. What should be the maximum amortization period or periods permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?*

**Generally, in cases of open amortization periods, we believe the amortization period should be chosen so that the initial amortization payment is at least equal to the interest on the unfunded liability. For closed amortization periods, we suggest a maximum amortization period of 20 or 25 years.**

Amortization periods are part of a plan's amortization policy, which includes all aspects of how unfunded liabilities are amortized. This means that the choice of amortization period should consider other features of the amortization policy, some of which are interrelated.<sup>19</sup> Key issues include:

- 1) Is the unfunded liability amortized as a single amount or in separate layers based on when and how the obligation arose?
- 2) If there are multiple unfunded liability layers, is the same amortization period used for all layers, regardless of source?
- 3) Are the amortization periods closed (i.e., declining periods with a fixed ending date) or open (i.e., rolling periods with an ending date that is extended each year)?
- 4) Are the amortization payments determined as a level percentage of payroll or as a level dollar amount?
- 5) Should unfunded liabilities be amortized over the same period as overfunded obligations (i.e., when the plan has a funding surplus)?

Within this framework, there are three general considerations that reflect the GASB's criteria of accountability and interperiod equity:

- 1) Matching the amortization period with the members receiving the benefit. This leads to periods based on demographic statistics, which could include the average working lifetime of active members, the average life expectancy of retired members, or the duration of the benefit payment stream.
- 2) Controlling expense volatility so that current taxpayers are not unduly favored or penalized by short term actuarial experience. This consideration generally leads to longer amortization periods, and so is balanced against the "matching" consideration above.
- 3) For level percentage of pay amortization, awareness of the issue of "negative amortization".

This last item warrants further discussion. One particular issue for public plans is "negative amortization," where the current amortization payments do not cover the current interest accruing on the obligation. This occurs when the following factors coincide:

- 1) The amortization method sets the amortization payment as a level percentage of projected payroll, rather than a level dollar amount, and
- 2) The amortization period is relatively long (generally approaching or exceeding 20 years).

Note that negative amortization is determined by the remaining amortization period, so that for closed amortization periods, it occurs only in the initial years of the amortization period.

Negative amortization is a natural consequence of level percentage amortization over periods approaching or exceeding 20 years. It is important to note that even during periods of negative amortization, the unfunded liability *is still being reduced as a percentage of payroll*. In other words, if you view the funding in wage adjusted constant dollars there is no negative amortization.

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<sup>19</sup> This discussion applies to plans where the employer's contribution is determined based on the normal cost and amortization of the unfunded liability. However, it does not apply to plans where the employer's contribution is set at a fixed rate. These plans are discussed at the end of this section.

While we do not believe that negative amortization makes an amortization policy actuarially unsound, we also understand that for very long amortization periods it is associated with shifting costs to future generations of taxpayers. Furthermore, for some users of financial reports any negative amortization may be a cause for concern.

A particular concern arises when negative amortization occurs in conjunction with open amortization periods. In this case, because the system is always in the first year of the amortization period, the unfunded liability never decreases in dollar amount, but only as a percentage of payroll. **Therefore, in cases of open amortization periods, the amortization period should be chosen so that the initial amortization payment is at least equal to the interest on the unfunded liability.**

For closed amortization periods, any recommended maximum amortization period should reflect a balance of all three considerations of demographic matching, volatility control and negative amortization. **If a closed amortization period is used, we suggest a maximum amortization period of 20 or 25 years. This minimizes the period of “negative amortization,” and provides a reasonable balance between demographic matching and volatility control.**

**Because so many systems have established expensing policies based on the current 30 year maximum amortization period, we further recommend that a five or ten year period be available for transition to this new limitation.**

With regard to fixed-rate plans, as discussed in GASB Statement 27, a large proportion of governmental plans are required by statute or established policy to maintain fixed or stable contribution rates. Such rates are often considered more equitable to taxpayers, since each generation bears a similar burden for similar services. Moreover, the stable rates facilitate budgeting for employers and provide for an orderly accumulation of assets.<sup>20</sup>

Because the contribution rate must remain stable (or is assumed to remain stable), the amortization period for fixed-rate plans is variable in the actuarial valuation. That is, the actuarial variability is absorbed by changes in the amortization period. As also discussed in GASB Statement 27, the use of an open amortization period for such plans helps to maintain the stable contribution rates and simplifies the calculations by avoiding the multiple layers of amortization that would otherwise occur if closed periods were required. **Therefore we believe fixed-rate plans should continue to be allowed to use open amortization periods which vary up to the maximum period.**

- c. *Should different maximum amortization periods be set for different types of changes to the unfunded accrued benefit obligation? Why or why not?*

**Yes. The nature of the event which generates changes to the unfunded obligation should be considered in setting the maximum period over which the change should be financed.**

- d. *If you answered yes to question 6c, what should be the maximum amortization period for benefit changes applied retroactively to past periods of service that were not substantively a part of the employment agreements that established the compensation for services in those periods or were not previously included in the projection of pension benefits? What should be the maximum amortization period for actuarial gains and losses? Why?*

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<sup>20</sup> GASB Statement 27, paragraph 111.

**For such retroactive benefit changes, we would support a shorter amortization period that is related to the period of time over which the expected gain in employee productivity is expected. A maximum period of fifteen years could be used as a reasonable approximation. This would also be a reasonable period to amortize benefit improvements attributable to retirees, as an approximation for the average lifetime of a retired group.**

**For early retirement incentives or other termination benefits which take the form of enhanced pensions, we would support amortizing the change over a substantially shorter period, possibly as short as five years. We note that the separate amortization of both the retroactive benefit changes and early retirement incentives should significantly improve accountability for benefit improvements.**

**For actuarial gains and losses and also for changes in actuarial assumptions and cost methods (with one exception), we support the longer amortization period (either open or closed) of 20-25 years that we recommended in part b of this question.** For actuarial gains and losses, this is because they are expected to both increase and decrease the liabilities. Consequently, they tend to offset each other and not push costs or savings onto future taxpayers. In order to maintain stable costs and control volatility, it is desirable to amortize actuarial gains and losses over a longer period.

As with actuarial gains and losses, some changes in actuarial assumptions and methods could be expected to both increase and decrease the liabilities, and so the same argument would apply. Even for such changes that are not expected to be offset by future changes, longer amortization periods are appropriate. These changes recalibrate the estimates on which cost measurements are based and are part of the longer term cost relationship between the taxpayers and plan members.

**The exception to the above is a change in actuarial assumption as a result of a benefit improvement. Such an assumption change should be amortized in the same manner as the associated benefit increase.** For example, a benefit increase which permits employees to retire early would necessitate an assumption that employees actually may retire early and take the increased benefit. Such a change is short term in nature rather than long term.

**Finally, while not strictly a change in obligation, we believe a minimum – not maximum – amortization period would be appropriate for plans in surplus (i.e., where assets exceed the accrued liability). This period should be at least as long as the period used for amortizing gains and losses.** We believe that the risks for plans in surplus are fundamentally different from those with unfunded liabilities. In particular, surpluses produce amortization credits which produce a net expense (and contribution) less than the current normal cost. This is an unstable condition for an ongoing plan. It accustoms employers to benefit costs that are less than the ongoing expected costs due to the amortization of the surplus – a condition that could quickly be reversed, such as by a downturn in the investment markets. Short amortization of the surplus actually increases this risk by accelerating the recognition of the surplus in the expense measure.

For that reason we recommend a relatively long minimum period for amortizing the surplus. Alternatively, another approach might be to require a note disclosure to alert report users if the net expense falls below the normal cost.

**We also believe that, for systems that apply multiple amortization periods for different components of the unfunded liability, it would be useful to allow (but not require) the different amortization layers to be combined periodically.** Exactly when this should be done might best be based on the plan's individual circumstances and the professional judgment of the actuary, provided the result meets the overall amortization goals.

e. *Which amortization method or methods should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?*

As discussed in our response to (b), we support:

- **Open amortization, even as a level percentage of payroll, as long as the amortization period is chosen so that the amortization charge is at least equal to interest on the unfunded liability;**
- **Closed amortization, as long as the period is no more than 20-25 years;**
- **Level dollar or level percentage of payroll amortization (note: growth in payroll should reflect payroll increases due to growth in average wages but not projected growth in covered membership);**
- **Amortization of the unfunded obligation as a single amount or in layers based on the timing and source of the obligation; and<sup>21</sup>**
- **Amortization periods for plans in surplus that are at least as long as the period used for amortizing gains and losses.**

f. *What method or methods of determining the actuarial value of plan assets should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?*

**We support actuarial asset valuation methods which satisfy Actuarial Standard of Practice No. 44.** We find that standard relevant and appropriate for accounting and financial disclosure and encourage the GASB to review that standard for guidance. Moreover, we support disclosure of the market value of assets, as a fair value of what the assets could be sold for in the market.

#### **Response to ITC Question 7**

**Question 7:** *Does the relationship between a cost-sharing employer and the cost-sharing multiple-employer plan in which it participates differ enough in economic substance from the relationship that a sole or agent employer has with the plan in which it participates to support different requirements with regard to liability and expense recognition? Which of the following views best represents your view, and why?*

- a. *The relationship does differ in economic substance, and current measurement, recognition, and disclosure requirements appropriately account for the pension cost and obligation of an employer in a cost-sharing plan.*
- b. *The relationship does differ in economic substance, and current measurement and recognition requirements are appropriate; however, additional disclosures by cost-sharing employers are needed.*
- c. *The relationship does not differ in economic substance; a cost-sharing employer has a long-term pension obligation based on the employment exchange and should measure and recognize its obligation and expense in a manner similar to that for sole and agent employers.*

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<sup>21</sup> We understand that this support for amortization as a single amount conflicts with our support for applying a shorter amortization period for retroactive benefit increases and early retirement windows. This needs to be developed further. Recognition as a single amount helps to manage volatility, while using separate amortization periods for benefit changes helps to improve accountability and interperiod equity.

**We believe that the relationship between a cost-sharing employer and its cost-sharing plan differs enough in economic substance from that of a single or agent employer and its plan to support the different treatment with regard to liability and expense recognition.**

As discussed in ITC Chapter 6, a cost-sharing multiple-employer plan is one in which the risks, rewards, and costs are pooled among all participating employers and are not attributed individually to specific employers. Each employer's annual contribution to the plan is essentially a contractual requirement which, when paid, fulfills the employer's contractual obligation to the plan. Consequently, the current treatment of the employer's contractually required contribution as an expense conforms to the treatment of other contractual obligations. Moreover, to the extent the employer does not contribute the full contractually required amount, the remainder represents a liability.

Because a single actuarial valuation is done for the cost-sharing plan as a whole and not for the individual participating employers, it would not be possible to reasonably assign separate annually required contributions (ARCs) to the individual employers without doing separate actuarial valuations. However, doing so would essentially make the plan an agent multiple employer plan, rather than a cost-sharing plan, defeating the purpose of the risk pooling. Even if individual ARCs were calculated for each employer, the employers would usually not have a way of paying the ARC, since each employer usually has no control over the amount it contributes.

**However, we also believe that the disclosure of additional information by employers in cost-sharing plans would be useful.**

Currently, employers in cost-sharing plans refer their financial report users to the plan's annual financial report for information about the plan, including its funded status, annual required contributions, and actual contributions made to the plan. In order to give the employer's financial report users a better sense of the financial condition of the cost-sharing plan, we believe certain information presented in the cost-sharing plan's financial statements should also be included in the participating employer's financial statements.

Consequently, we believe the employer's financial report should include plan information in its Required Supplementary Information (RSI), including information about the funded status of the plan, annually required contributions, and actual contributions made to the plan over a period of time (perhaps three years). In addition, relevant statistics should be included in the employer's notes or RSI to indicate how large the employer is compared to all other employers in the cost-sharing plan. Such information could include member counts, payroll, and contributions, presented both for the employer and for the plan as a whole. This would allow the financial report users to make their own judgments about the employer's potential future liability to the cost sharing plan. The GASB might also want to consider whether some threshold size of some participating employers relative to the entire plan changes the nature of the cost-sharing plan.

#### **Response to ITC Question 8**

**Question 8:** *Which of the following should a pension plan report as its liability in regard to pension benefits, and why?*

- a. A liability for benefits currently due and payable*
- b. The accrued benefit obligation, however measured*

**We believe that the liability for pension benefits recognized in the plan’s statement of financial position should be the benefits currently due and payable.**

We believe the current plan reporting model, as adopted in Statement 25, accurately reflects the plan’s roles and responsibilities. Within this framework, as discussed in the ITC, the information presented in the plan’s financial reports should be relevant to the trustees’ stewardship of the plan’s assets, for which they are accountable. This is the primary focus of the Statement of Plan Net Assets, which under Statement 25 is the plan’s statement of financial position. In the Statement of Plan Net Assets, the pension benefit liability reflects benefits currently due and payable.

We also agree with a statement made in the ITC that “it is doubtful that plan trustees or administrators would be legally responsible for the payment of accrued benefits in excess of the plan assets in a plan that was less than fully funded.”<sup>22</sup> Consequently, in the context of plan financial statements, the accrued benefit obligation would not meet the Concepts Statement 4 definition of liabilities as “present obligations to sacrifice resources that the government [in this case the plan] has little discretion to avoid.” Therefore, we believe the accrued benefit obligation does not constitute a liability of the pension plan and should not be recognized in the plan’s statement of financial position.

#### **Response to ITC Question 9**

**Question 9:** *Should a presentation of changes in the unfunded accrued benefit obligation be a required part of general purpose financial reporting? Why or why not?*

- a. If yes, which financial report(s) should contain that presentation: The employer’s, the plan’s, or both? Why?*
- b. If yes, should the presentation be a basic financial statement, a note to the basic financial statements, or required supplementary information? Why?*

**We believe that information about changes in the unfunded accrued benefit obligation would be useful to include in both the employer’s and the plan’s annual financial reports; however, it should be reported in the notes to the financial statements or in the RSI and not in the financial statements.**

As discussed in our responses above, we do not believe the unfunded accrued benefit obligation should be recognized as a liability in the employer’s financial statements, nor do we believe the accrued benefit obligation should be recognized as a liability in the plan’s financial statements.

However, we do believe that information about the primary components of changes in the unfunded actuarial accrued liability (UAAL) would be useful in helping financial report users understand the underlying dynamics of the plan. We do not believe this should be reported in the financial statements, but rather should be included either in the notes to the financial statements or the Required Supplementary Information (RSI).

If such information is included, it should be provided in a consistent manner. The table at the end of our response to Question 3 showing the reconciliation of the UAAL may be useful in this regard. In addition, it might be useful to report key items of the UAAL reconciliation over multiple periods in order to give financial report users an understanding of the changes in these items over time.

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<sup>22</sup> GASB Invitation to Comment, p. 59.