

August 6, 2009

Director of Research and Technical Activities

Project No. 34

Via email: [director@gasb.org](mailto:director@gasb.org)

We are responding to the GASB's Invitation to Comment on possible revisions to Statements 25 and 27. We appreciate the Board's interest in these statements and the Board's willingness to consider our perspectives. Together, we represent the fiduciaries, administrators, and plan members of 61 public retirement systems holding in trust more than \$1.2 trillion and providing retirement security on behalf of thousands of public employers for over 12 million working and retired public employees. As such, we represent both users as well as preparers of public retirement system financial reports.

By our signatures, we substantially agree with the views presented in this response; however, there are some areas where one or more of us may have a slightly different perspective, which will be shared with GASB in several systems' separate responses to the ITC.

In general, we believe that GASB Statements 25 and 27 in their present form adequately inform users about the financial condition of public pension plans and meet the GASB goals related to accountability and decision-usefulness. The two key questions related to pension benefits are 1) how much must the plan sponsor contribute to fund the benefits over time, and 2) has the sponsor made the required contributions? The first question is directly answered by the annual required contribution; the second is directly answered by the net pension obligation.

Thus, we would encourage the GASB to proceed with caution in making major modifications to these statements. A wide array of users, including state legislators and other policymakers; public employees and employers; executive officials, such as governors, mayors, treasurers, and comptrollers; members of the media; and bond rating services have become accustomed to accessing information from public retirement system financial reports that comply with current GASB standards.

Significant changes to this reporting model could result in confusion on the part of the user community and could disrupt the consistency of public pension reporting. Such confusion and inconsistency could in turn reduce accountability and decision usefulness of public retirement system financial reporting.

Opportunities do exist, however, for improvement in Statements 25 and 27. Among our comments that follow related to questions posed in the ITC, we also have identified certain areas in which GASB may wish to consider revisions to the existing statements.

## Question 1.

We believe that public pension financial reporting should focus on the process by which benefits are financed. The finance focus promotes decision usefulness by being consistent with the perpetual nature of government and governmental plans' operating and legal environment—that of an enduring, going concern, providing retirement benefits that generally are guaranteed by some combination of state constitutions, statutes, and case laws.<sup>1</sup>

Focusing accounting standards on the finance process also is consistent with the actuarial funding process used by public pensions, in which assets to fund future benefits are accumulated as services are provided. A primary purpose for conducting a public pension actuarial valuation is to determine the cost of funding the plan and to assign those costs to time periods. Linking accounting and actuarial processes in this manner advances interperiod equity by seeking to fairly distribute costs associated with the provisions of public services among generations of taxpayers. Over the long-term, this fair distribution of costs among generations is more likely to be accomplished when the costs reflect the actuarial methods used to fund the plan and are expressed as a level percent of payroll for covered employees.

Focusing on the incurrence approach would result in unnecessary and undesirable volatility and inconsistency of pension obligations and required costs. Removing the link between accounting and funding would result in less useful information for purposes of public sector budgeting. We believe that focusing on *both* the finance and the incurrence processes would, as described above, cause confusion, challenging the report's decision usefulness and violating interperiod equity. We continue to be concerned that, as the GASB notes in paragraph 73 of Statement 27, providing accounting measures of pension information that vary from those produced by the funding methodology could potentially be misleading for legislators, public officials, and others who must make decisions about benefit levels and contribution rates. Focusing on both processes also could invite selective use of data, again violating the principle of decision usefulness.

We believe, however, that the GASB might wish to consider adding a requirement that public pension financial reports present as required supplementary information changes in the plan's unfunded actuarial accrued liability (UAAL) resulting from differences between the plan's experience and actuarial assumptions, and from benefits approved during the reporting period. This information typically is presented in the plan's actuarial valuation. The GASB may also wish to consider requiring this information on an historical basis, such as over a five-year period. Presenting this information may satisfy the interest of those seeking that plans communicate changes to the UAAL that occurred during the reporting period.

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<sup>1</sup> See <http://www.nasra.org/resources/pension%20protections.pdf> for a list of state-by-state protections of public pension benefits.

## Question 2.

For the reasons listed below, we believe the current standard for reflecting a pension liability—the difference between amounts paid based on the employer’s Annual Required Contribution and amounts actually contributed—is appropriate.

- This approach promotes interperiod equity by evenly distributing over the plan’s amortization period the sum of the normal cost and the cost to amortize the unfunded liability.
- Because the unfunded accrued benefit obligation is based on future, projected events, it is uncertain and cannot be measured with a high degree of reliability. For example:
  - As noted in paragraph 74 of GASB Statement 25, “Actuarially determined amounts are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. In the board’s view, requiring those amounts to be displayed in the financial statements implies a precision and reliability as of the reporting date that is inconsistent with the nature of actuarially determined pension information.”
  - Actuarial Standards of Practice No. 4 directs actuaries in their reporting to include a statement, “indicating that future measurements (for example, of pension obligations, costs, contributions, or funded status as applicable) may differ significantly from the current measurement.”<sup>2</sup>
  - Concepts Statement 3. Paragraph 33 states: “Items recognized in a financial statement are intended to provide reliable representations of the effects of transactions and other events.”
- A more meaningful figure for users of financial reports is how well the government is funding its obligations, as expressed via the net pension obligation.
- Under the current standard, the unfunded liability is disclosed, in notes to the financial statements.
- Not every obligation constitutes a liability that needs to be disclosed in the statement of net assets. Liabilities are present obligations to sacrifice resources that the employer has no discretion to avoid. The components used to measure that liability should be relatively fixed and not subject to change.

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<sup>2</sup> ASOP 4 also provides a sample statement as follows: "Future actuarial measurements may differ significantly from the current measurements presented in this report due to such factors as the following: plan experience differing from that anticipated by the economic or demographic assumptions; changes in economic or demographic assumptions; increases or decreases expected as part of the natural operation of the methodology used for these measurements (such as the end of an amortization period or additional cost or contribution requirements based on the plan’s funded status); and changes in plan provisions or applicable law."

### **Question 3.**

We believe that interperiod equity is best achieved through deferred recognition of pension costs amortized over a period of years. This approach is consistent with both the long-term, enduring nature of public sector entities and their obligations, and with the nature of actuarial benefit obligations, which are uncertain and often volatile. Deferring recognition also is in harmony with the finance method discussed in Question 1.

Deferred recognition has support in the GASB White Paper, “Why Governmental Accounting Is—And Should Be—Different,” which states,

“The longer term view of operations of government is consistent with focusing on trends in operations, rather than on short-term fluctuations, such as in fair values of certain assets and liabilities. ... [I]t is not appropriate for government employers to immediately recognize those fair value changes or changes in accrued actuarial liabilities resulting from a change in benefit plan terms. These short-term fluctuations could produce a measurement of the period’s employee benefit costs, which are included in cost of services, that may be less decision-useful for governmental financial report users. Financial reporting by business enterprises is more likely to recognize such changes in fair value because of the importance of the current value of equity. ... [G]overnments have no compelling reason to frame or orient financial statements in a way that is primarily focused on facilitating decisions of an equity market or of equity investors, which typically use financial reporting to assess the value of their ownership interest and whether that value is increasing or decreasing.”

Recognizing changes annually in the unfunded accrued benefit obligation would result in significant volatility, causing uncertainty and challenging the principles of decision usefulness. This volatility also would violate interperiod equity by overcharging some taxpayers and undercharging others, depending upon the timing and direction of the volatility.

### **Question 4.**

We believe that current GASB standards are appropriate in including projected automatic COLA’s, projected future salary increases, and projected future service credits. In light of public pensions’ status as enduring, going concerns, these obligations are likely to be paid in the future. Constitutional and statutory provisions and case laws protect pension benefits for employees of state and local government. In many cases, these protections extend to the continued accrual of future service credits, and they generally preclude freezing or termination of pension benefits for active plan participants.

Therefore, failing to include these projected benefits would fail the tests of a) accountability, by ignoring costs that will be paid; b) decision usefulness, by denying users information relevant and material to the plan’s obligations; and c) interperiod equity, by failing to identify funding in the current period necessary to pay for benefits being earned that have a high likelihood of being paid, thereby shifting their cost to future generations. Failing to include these projected benefits

also may violate plan fiduciaries' obligations in cases where there is a reasonable expectation that these benefits will be paid.

An example of not including projected benefits in actuarial calculations took place at the Texas Municipal Retirement System, which used the unit credit actuarial cost method from the late 1940s until 2007. This method did not account for projected annually repeating COLAs and other benefit accruals. The average employer contribution rate at the TMRS in 2007, was approximately 10 percent; the plan, in the aggregate, was funded at 82.1 percent. After deciding to advance fund certain benefit features including annually repeating COLAs, and switching to the projected unit credit method, the average employer contribution rate rose to approximately 15 percent and the plan's aggregate funding level declined to below 74 percent. Most of the funding level decline and higher contribution rate was attributed to the decision to advance fund annually repeating benefits in the plan. This experience highlights the fiscal impact of the delayed decision to project annually repeating COLAs (which most TMRS employers provide), and future salary increases on benefit accruals.

We believe that no meaningful purpose is served in requiring public pension plans to calculate or report a value without projecting future benefits when there is a strong likelihood those benefits will be paid.

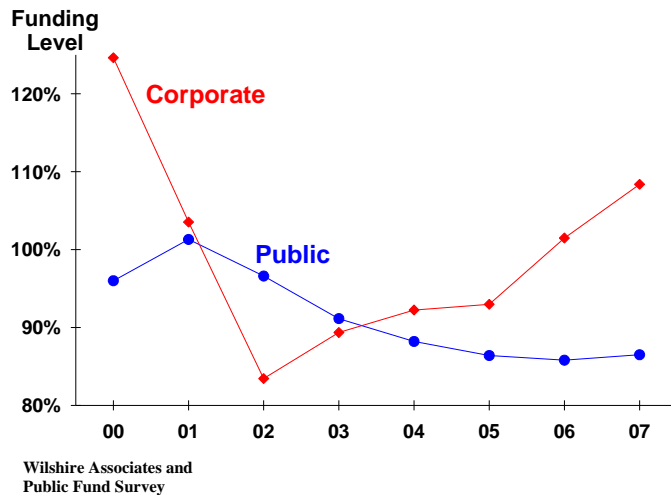
#### **Question 5.**

We believe the rate for discounting projected pension benefits to their present value for accounting purposes should be the plan's estimated long-term investment return based on the plan's asset allocation. This method is consistent with both the perpetual nature of governments and the enduring, long-term nature of public pensions. This method also is the most likely to promote interperiod equity, because the long-term investment return assumption is the plan's best estimate of future earnings from investments, which are the fund's largest revenue source.

Discounting future benefits on the basis of a "risk-free" rate fails the test of interperiod equity. As an illustration, the chart nearby compares the funding level of public and corporate pension plans for the period 2000 through 2007. FASB standards require corporate pensions to measure their funding level on the basis of a "risk-free" investment return. This requirement results in extreme funding level volatility, driven largely by fluctuating interest rates. By contrast, the public pension funding levels have been relatively stable, due primarily to two factors: a consistent investment return assumption based on plans' long-term expected return, and actuarial smoothing of assets.

Similarly, a recent study by Jones, Murphy, and Zorn found that using a risk-free discount rate (based on 30-year U.S. Treasury yields) would introduce significant volatility into public pension

funding levels and contributions.<sup>3</sup> The study compared the conventional actuarial approach used by the majority of public plans with the “market value of liabilities” (MVL) approach (which uses the risk-free discount rate) over the period from 1978 to 2008. It found that contribution rates under the MVL approach would have varied from about 3% of covered payroll in the mid-1980s (when 30-year Treasury yields were close to 14%) to about 40% of covered payroll in the mid-2000s (when Treasury yields were close to 4%). Under the conventional approach, which uses a discount rate based on expected investment returns, contribution rates ranged between 8% and 14% of covered payroll over the study period.



The volatility in funding level and required costs brought by a risk-free return for discounting future pension benefits is needless and avoidable. This volatility and uncertainty would promote not only inconsistency in the measurement and disclosure of pension information, but also would disrupt public sector budget processes. Predictability and stability of required costs are hallmarks of public sector budgeting, and the imposition of elements that would cause wide swings in required pension costs would be unnecessarily disruptive.

Moreover, requiring public sector pensions to discount future benefits on a termination basis violates the principles of decision usefulness and interperiod equity.

The use of a discount rate based on bond interest rates is consistent with the calculation of a termination liability. Actuarial Standards of Practice No. 27 directs actuaries measuring a plan’s termination liability to use an investment return rate based on interest rates implicit in the purchase of an annuity. Yet, states and their political subdivisions are going concerns with very

<sup>3</sup> “The Rationale for Traditional Actuarial Models: Actuarial Methods and Public Pension Funding Objectives: An Empirical Examination,” Norman L. Jones, Brian B. Murphy, Paul Zorn, Society of Actuaries Public Pension Finance Symposium, May 2009

long time horizons, continuous revenue streams and greater sustainability than other pension plan sponsors.

Discounting future benefits with the use of a risk-free rate also fails the test of decision usefulness because this approach is based on an assumption about future events that is fundamentally in conflict with the nature of the public sector. Requiring the use of a risk-free rate also would violate interperiod equity by charging current taxpayers on the basis of present interest rates, rather than a long-term expected rate. This would result in disparity, sometimes substantial, in what generations of taxpayers are charged for pension benefits.

#### **Question 6.**

We support the retention of a maximum amortization period of 30 years, as we believe this timeframe is most consistent with the long-term nature of public sector entities and provides pension plans the flexibility to employ amortization periods that are shorter, should the plan find that to be prudent.

We also believe, however, that the GASB should consider requiring plans to report an amortization period that is projected to result in negative amortization, accompanied by appropriate detail informing users of the projected length and dollar amounts associated with the negative amortization, including the point at which the amortization is projected to become positive.

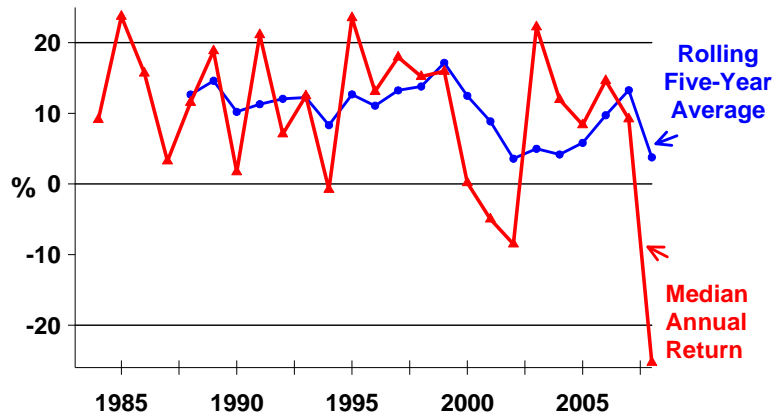
We support the continued authority to use both level percentage of pay and level dollar amortization methods, as different circumstances, unique to each plan, may justify the more appropriate use of one or the other. For the same reason, we also support the continued authority of plans to use both open and closed periods.

With respect to the method for determining the actuarial value of plan assets, we believe that plans should continue to be permitted to phase in investment gains and losses over multiple years. This approach reduces volatility in plan funding levels and required costs, and increases consistency of reporting. Investment markets are subject to extreme volatility, as has been demonstrated in recent years. Accordingly, we believe that no useful purpose is served by requiring public plans to use a point-in-time measure of funding level, used to calculate required costs, when these plans are going concerns.

Asset smoothing also promotes consistency in financial reporting by rounding out the sharp peaks and valleys of annual investment returns. Investment returns from a diversified portfolio vary widely, yet, over time, investment earnings are the largest source of public pension fund revenue. Thus, the assumed investment return has a major effect on a plan's funding level and required contributions. Forbidding the use of smoothing would significantly increase the

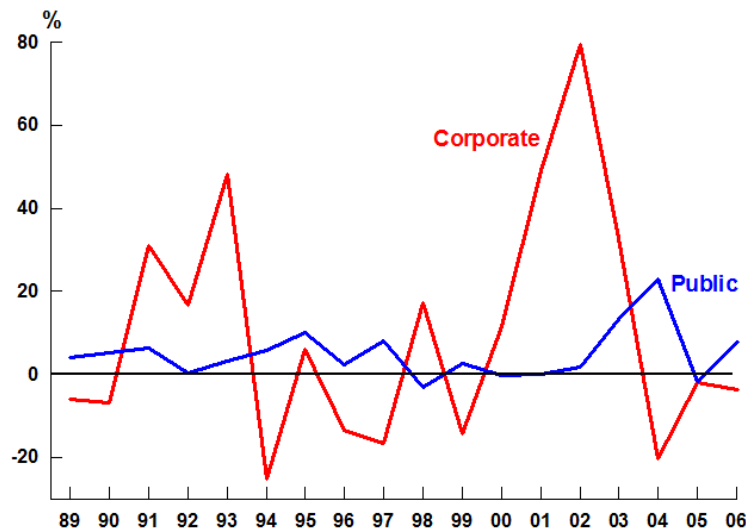
exposure of public plan funding levels and required contribution rates to the vicissitudes of investment markets.

The chart nearby compares the median annual return for public pension funds for the 25 years ended in 2008, with the rolling five-year average for the same period. This chart illustrates the volatility of annual investment returns and shows how smoothing (approximated by the rolling average) moderates that volatility. For the period shown, the average standard deviation of the median annual return was 11.3, compared to 3.9 for the rolling five year average.



NASRA based on Callan Associates data

As a result of actuarial smoothing of assets, public pension plan funding levels (as shown in a previous chart) and required contributions (as shown in the chart below) have experienced far less volatility than corporate pensions, and have been more stable than they would have were actuarial smoothing not permitted.



Some advocates of change in GASB standards have expressed interest in increasing comparability among public pension plans. Although, on an academic basis, we might appreciate the desire to compare plans to one another, we also believe that true comparability is elusive, chiefly because every plan and plan sponsor is unique, defined by variables that are specific to the plan and its plan sponsor(s). These variables include:

- the level of required employee and employer contributions;
- the plan sponsor(s)' commitment and ability to make required contributions;
- the fiscal condition of the plan sponsor;
- the plan's demographic makeup;
- the level of benefits provided by the plan;
- the plan's governance structure, including the ability (or inability) to modify the plan design, including benefit levels and contribution rates;
- the plan sponsor's level of support for the pension plan;
- the plan's amortization period(s);
- required benefit payments in the current and future years relative to the plan's asset base; and
- the pension fund's investment performance, risk tolerance, and expected investment return.

Taken together, the differences in these variables complicate meaningful comparability among public pension plans with the use of a single figure, such as the actuarial funding ratio. The act of comparing apples to oranges does not in fact create comparability between them, and not only makes the exercise fruitless but also misleading.

#### **Question 7.**

We believe the current approach to accounting for the cost sharing employer and cost sharing multi-employer plans is sufficient and should be continued.

#### **Question 8.**

As mentioned in our response to Question 1, we believe GASB should consider adding a requirement that public pension financial reports present as required supplementary information changes in the plan's unfunded actuarial accrued liability (UAAL) resulting from differences between the plan's experience and actuarial assumptions, and from benefits approved during the reporting period. This information typically is presented in the plan's actuarial valuation. The GASB may also wish to consider requiring this information on a historical basis, such as over a five-year period. Presenting this information may satisfy the interest of those seeking that plans communicate changes to the UAAL that occurred during the reporting period.

## Question 9.

As mentioned in our response to Question 1, we believe GASB should consider adding a requirement that public pension financial reports present as required supplementary information changes in the plan's unfunded actuarial accrued liability (UAAL) resulting from differences between the plan's experience and actuarial assumptions, and from benefits approved during the reporting period. This information typically is presented in the plan's actuarial valuation. The GASB may also wish to consider requiring this information on a historical basis, such as over a five-year period. Presenting this information may satisfy the interest of those seeking that plans communicate changes to the UAAL that occurred during the reporting period.

Thank you for your consideration of our views on this issue.

Sincerely,

Dr. David Bronner, CEO, Retirement Systems of Alabama

Dr. Paul Hubbert, Chairman, Teachers' Retirement System of Alabama

Mac McArthur, Executive Director, Alabama State Employees Association

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Gary Findlay, Executive Director, Missouri State Employees Retirement System  
Gary Irwin, Chief Finance Officer, Missouri State Employees Retirement System  
Michele Nix, CPA, Assistant Chief Finance Officer, Missouri State Employees Retirement System  
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Nicki Russell, CPA, CIA, Internal Auditor, Missouri State Employees Retirement System  
Shannon Davidson, CPA, Manager of Risk & Performance, Missouri State Employees Retirement System  
William Schwartz, Executive Secretary, Missouri Local Government Employees' Retirement System  
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Warren Whitney, Chair of the Vermont State Retirement System Board of Trustees  
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Cynthia L. Webster, Executive Secretary to the Vermont Retirement Systems and Director of Vermont Retirement Policy and Outreach  
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