



July 25, 2009

Director of Research and Technical Activities, Project No. 34  
Governmental Accounting Standards Board  
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[director@gasb.org](mailto:director@gasb.org)

Re: Pension Accounting and Financial Reporting  
Invitation to Comment

Dear Sirs:

This is in response to the GASB Invitation to Comment on the re-examination of pension accounting and financial reporting standards.

SACRS, an acronym for the State Association of County Retirement Systems (the Association), is an association of 20 California county retirement systems, established under the County Employees Retirement Law of 1937 (CERL), California Code section 31450 et seq. The CERL governs the benefits and administration of these county retirement systems.

On behalf of the twenty pensions systems, we want to thank you for the opportunity to review and comment on the nine areas that are being re-examined.

SACRS believes that after ten years of providing guidance, GASB Statement No. 25, Financial Reporting for Defined Benefit Pension Plans and Statement No. 27, Accounting for Pensions by State and Local Governmental Employers, are quite adequate in their current form. However, we would like to suggest some areas for clarification and improvement.

If you wish future clarification or to discuss our responses in further detail, please feel free to contact us through our interim Executive Director, Robert Palmer ([SirBPalmer@aol.com](mailto:SirBPalmer@aol.com)).

Sincerely,

Richard A White  
President, SACRS

**Question #1. Chapter 2: Focus of Accounting and Financial Reporting for Pensions**

This question focuses on the processes related to pensions and which are most appropriate for governmental accounting and financial statements.

How an employer incurs an obligation to its employees for pension benefits is one thing; how that same employer finances pension benefits can be quite another. For financing purposes, public-sector employers have tended to favor actuarial funding methods which produce annual contribution amounts that can be expected to remain relatively constant over time as a percentage of payroll. Current GASB standards for the public sector essentially focus on funding, within predetermined parameters. Private-sector pension guidance, on the other hand, focuses more on the employer's incurrence of an obligation to employees.

Because of concerns with business and financial stability as well as recognition of outstanding liability costs, it is understandable why the private sector needs to have an "incurrence of an obligation" approach to reporting. However, we believe that the incurrence approach, which focuses on interperiod equity, would lead to greater volatility, with wide swings and poor linkage between accounting and funding.

Public sector retirement benefits are guaranteed by statute and court rulings. Public agencies are long-term entities. Public employers prefer to have stable contribution rates. Actuarial valuations, that determine the costs of funding the plan and assign those costs to appropriate time frames, are more acceptable to public employers and well accepted in the public pension arena.

**Question #2. Chapter 3: Issues Related to Liability and Expense Recognition**

This section considers the fundamental issue of what defined benefit processes, transactions, or other events should be the focus of financial reporting. It asks whether pension financial reporting should be based on either the process by which the employer incurs an obligation to employees or the process by which an employer finances its projected future cash flows, or both processes.

Not every obligation is necessarily a liability for accounting and financial reporting purposes. Currently, a state or local government employer does not show a liability on the face of the financial statements for the employer's unfunded accrued obligation to employees for benefits already earned. On the other hand, employers are required to report a liability for the cumulative effect of any failure on their part to fully fund their annual required contributions (ARC) to finance future benefit payments (consistent with a funding focus). An alternative would be for employers to report the entire unfunded accrued benefit obligation as a liability on the face of the financial statements, as in the private sector.

The question is which approach provides a better measure of liability. An incurred approach is subject to projecting events. To measure the employer's unfunded accrued benefit obligation against future expectations of an employment agreement could lead to many uncertainties. Since a public entity has longevity, it is not necessary to recognize the entire unfunded accrued benefit obligation as a liability the way it must be reported in the private sector.

We believe that it is in the best interests of liability and expense recognition to maintain the current method which measures the difference between the employer's annual required contribution and the actual amount contributed. This approach measures how well the employer is funding its pension obligations on a year-to-year basis. The difference between the ARC and the actual contributions made show how well the employer is actually tracking with its annual pension obligations.

### **Question #3. Expense Recognition**

Under the accrual basis of accounting, the effect of transactions and events is normally recognized in the financial statements when they occur. However, in the case of pension accounting, the recognition of the effect of certain events and transactions may occur only gradually (i.e., amortization). Deferred recognition of costs is appropriate to an entity, such as a public entity, which has an unlimited future existence. Historically, public pensions have recognized pension costs through an amortized period of time.

The question being presented is how to reconcile this approach in relation to the principle of interperiod equity (i.e., "financial reporting should help users assess whether current-year revenues are sufficient to pay for the services provided that year and whether future taxpayers will be required to assume burdens for services previously provided according to GASB Concepts Statement No. 1, Objectives of Financial Reporting, paragraph 61). The opposite issue that is being raised is intergenerational transfer (i.e. allowing the costs for pension benefits for current employees to be extended well beyond their working careers to later generations of tax payers).

With the average working career of a pension member in the range of ten to fifteen years, the funding period for pension benefits must be flexible to allow plan trustees to set the time frame to meet specific benefit costs. Prospective benefits may possibly be funded within the career period of the employee. Benefits that are retroactive may require longer periods of time. Although interperiod equity is an important principle to strive for, it should not become an impediment for a well-reasoned funding period. This may result in intergenerational transfer of some costs.

Recognizing the effects of transactions and other events that affect the unfunded accrued benefit obligation as they occur each year can result in significant volatility. This volatility will, in all likelihood, lead to overcharging or undercharging taxpayers in relation to services provided. As a result, this approach would not solve the concerns of interperiod equity. Deferred recognition of some or all components of pension costs (other than normal cost) over a number of future years, as determined by the plan trustees and within accounting parameters, is more appropriate. Public pensions are stable, long-term entities. Therefore, amortization over future periods for expense recognition is appropriate.

**Question #4. Chapter 4: Approaches to Measurement**

The question is raised as to whether or not pension benefits such as: 1) automatic cost-of-living adjustments (COLAs); 2) ad hoc COLAs that are regular and re-occurring; 3) projected future salary increases; and 4) projected future service credits, be included or excluded in cost projections.

A pension formula typically applies not just to today's salary levels but to future salary levels upon the completion of service. Those future salary levels will typically reflect intervening events (e.g., cost-of-living adjustments and projected salary increases). Current GASB standards include such factors in the calculation of the employer's unfunded accrued benefit obligation for benefits already earned.

Benefits should be calculated and projected into future costs where there is a clear expectation that they will be paid. Constitutional and statutory provisions as well as case law have historically protected pension benefits for employees of state and local government. In many cases, these protections extend to the continued accrual of future service credits. These protections generally preclude freezing or termination of pension benefits for active plan participants.

We see no reason that where future benefits are known they should not be included in future cost projections.

**Question #5. What should be the basis for determining the discount rate used for projected pension benefits to their present value of accounting?**

Under current GASB standards, anticipated earnings on amounts placed in the trust reduce the calculation of the public employer's unfunded accrued benefit obligation. Currently, the appropriate discount rate used for this purpose is the pension plan's estimated long-term investment yield.

Public pensions are and should be viewed as perpetual entities by their very nature. As part of government, the legal (court) and statutory authority provides ongoing protections. For accounting purposes, and for long-term continuity, the pension plan's estimated long-term investment return must be based on the individual plan's asset allocation.

The "risk-free" rate approach is totally unnecessary for an entity with no real possibility of merger, acquisition or termination. The "risk-free" approach greatly under-estimates the potential of an active investment market. This approach will result in higher contribution rates by both the plan sponsor and the participants in order to make up the short fall of lower investment returns.

#### **Question #6. Chapter 5: Issues Related to the Use of Actuarial Methods**

This section focuses on the amortization of some components of pension cost for purposes of recognition of an employer's expense. In current public pension accounting, the effect of certain events and transactions may sometimes be deferred and amortized over future periods.

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

GASB standards currently allow six methods, reflecting a variety of funding approaches, whereas private-sector standards mandate the use of a single approach that is closely related to the employer's unfunded accrued benefit obligation. All six methods are held to be valid approaches. Because of the wide variation in public pension structures, GASB should continue to allow pensions to determine and select the most appropriate method for their particular circumstances.

- b) What should be the maximum amortization period permitted for accounting and financial reporting?

The retention of a maximum amortization period of 30 years for new benefits should be retained. Current GASB standards allow up to 30 years, whereas private-sector standards mandate a much shorter period.

Unlike the private sector where there is mounting concern that pension funding time frames need to be restrictive, public entities should be considered as having an unlimited time horizon for meeting their financial obligations. We continue to support the option of allowing amortization periods of up to 30 years.

- c) Should different maximum amortization periods be set for different type of changes to the unfunded accrued benefit obligation?

Public pensions should have the opportunity to select an appropriate funding timeframe based on the particular benefits. Motivation to limit the private sector on amortization periods is driven by a number of factors which do not apply to the public sector: 1) profitability; 2) answering to stockholders who have voluntarily invested in the business; 3) concerns with sudden possibilities of mergers, acquisitions and outright termination of plans that require Pension Benefit Guaranty Corporation (PBGC) involvement - - do not exist in the public sector. The actuarial constraints that may be justified for the private sector are inappropriate and unnecessary in the public sector. Given the long-term stability of public entities, investment gains and losses should be allowed to be phased-in over multiple years.

d) What should be the maximum amortization period for benefit changes applied retroactively to past periods of service?

Public pensions should have the ability to select an appropriate funding timeframe based on the particular benefits. As stated earlier, public entities should be considered as having an unlimited business time horizon. However, there should be a limit that requires promised benefits to be paid within a member's lifetime, if not the member's employment period. Concerns have been raised that amortization periods should strive to meet the principle of interperiod equity. This may not be realistic. However, GASB should require plans to report selected benefit periods that are extended to create a negative amortization. This is significant and should be disclosed. It would be another approach to the principle of interperiod equity.

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

The current selection of methods should be retained. Amortization may be calculated as a level percentage of payroll or as a level dollar amount. Likewise, amortization may occur over either a fixed period (closed amortization) or a rolling period (open amortization). As long as it is properly reported in the financial statements, public pension plans should be allowed maximum flexibility.

f) What method or methods of determining the actuarial value of the plan assets should be permitted for accounting and financial reporting purposes?

Under current standards, averaged market-related values are used to minimize the effects of market volatility. Plans should continue to be allowed to phase-in investment gains and losses over multiple years. This approach lowers volatility in plan funding obligations, leads to a more stable contribution rate and results in more consistent reporting. The valuation of the funds of a pension is becoming

more imprecise. For example, some alternative investments must be valued in arrears. Smoothing techniques help to mitigate these events.

“Point-in-time” measurements of funding result in volatility that is unnecessary to a long-term entity and would only lead to confusion and undue concern for the stakeholders.

### **Question #7. Chapter 6: Accounting by Employers in Cost-Sharing Plans**

This issue focuses on the relationship between the costs of a single public employer and cost-sharing between multiple public employers. As a general position, there should be no difference in economic substance. All cost-sharing public employers have a long-term pension obligation based on the specific benefits granted to their employees. Each should measure accounting and financial statements in the same manner as that of a sole employer.

This specific topic goes on to focus on liability or expense recognition. Each public employer retains all of the risk for the pension benefits promised to its employees. In many cases, public employers do participate in cost-sharing multiple employer plans where employees from various employers are combined into a single risk pool.

As we understand the question, in the private sector, employers account for their participation much as they would account for insurance. That is, if there were a future funding problem, it would be the plan’s problem, not the employer. This is not the case for public plans.

The public agency that acquires the responsibility of the legacy agency must also address the pension obligation as well. This is common practice in the public sector. Unlike the private sector where a business may terminate its functions, the unique nature of the public sector requires another public entity to assume the responsibilities of the legacy agency. As public districts are consolidated, for example fire districts, one issue that must be addressed is the continued funding of the pension obligations of the transitioning employees.

In the unlikely event that there is no acquiring agency, public pensions would calculate the specific employer’s assets to the liabilities close the plan and provide eligible members and retirees a reduction of the entitled benefits if the plan was not fully funded. The other employers in the pool would have no liability responsibilities because they were part of the cost-sharing pool.

Public employers who participate in cost-sharing plans should use the same accounting and financial reporting as those who sponsor single public employer plans. The general advantage for the pooling is in sharing member and investment risk.



**Question #8. Chapter 7: Issues Specific to Reporting by Plans**

The “Invitation to Comment” asks whether a pension plan should report its liability for benefits in one of two methods: “currently due and payable” or as the “accrued benefit obligation”.

Currently, neither public employers nor pension plans are required to present changes by the unfunded accrued benefit obligation. By recognizing a liability only for benefits that currently are due and payable omits essential information about long-term benefit liabilities that are necessary to make the plan financial statements complete.

As stated in the Invitation to Comment, the accrued benefit obligation pertains to the employer and, to that extent, should be recognized as a liability of the employer. It is not a liability of the plan or its trustees or administrators and should not be recognized as a liability in the plan financial statements.

**Question #9. Unfunded Accrued Benefit Obligation and Financial Reporting**

This question focuses on whether a presentation of changes in the unfunded accrued benefit obligation should be a required part of the general purpose financial reporting.

Under current standards, public pension plans do not report a liability for either the unfunded accrued benefit obligation or cumulative under-funding by employers. Instead, they report a liability only for benefits currently due and payable.

We would prefer to continue with the current practice.

However, as we read through the questions, it is quite clear that the GASB wants to focus more on the unfunded accrued benefit obligation in financial statements. We believe that any changes in the unfunded accrued benefit obligation should be a part of the general purpose financial reporting of the employer. This liability is an obligation of the employer, and therefore should be contained in the employer’s presentation. If the changes are of significance, then the matter should be fully addressed in the employer’s financial report. If less material, a note to the financial statements is appropriate.