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September 28, 2011

Norwalk, CT 06856-0659

Re: Comments on Project No. 34-E Proposed GASB Statement, Accounting and Financial Reporting for Pensions, an amendment of GASB Statement #27.

## Dear Mr. Bean:

The Association of Local Government Auditors (ALGA) welcomes the opportunity to submit comments on the Exposure Draft of the proposed GASB Statement on Accounting and Financial Reporting for Pensions. Our organization represents 325 audit organizations, totaling more than 1,750 members.

ALGA believes that the proposed standard as drafted would bring about an improvement in the accounting and financial reporting for pensions, but should not be considered a final solution. Consideration should be given to altering the guidance provided with respect to the investment return assumption to make it more conservative. Evaluation of the impact of the pronouncements on the funded status of pension plans is also appropriate.

In analyzing the proposed changes, it is important to evaluate the objectives intended to be accomplished by the proposed standard. The objectives stated in the exposure draft focus strictly on improvements that can be made in the accounting and financial reporting for pensions. We are aware that the GASB began looking at improving the accounting and financial reporting for pensions in 2006, well before the most recent economic downturn, but even at that time concern about the underfunded status of many governmental pension plans was undoubtedly a significant catalyst for the development of the proposed standard.

Improving the accounting and financial reporting for pensions and improving the funded status of governmental pension plans are two separate and distinct desired outcomes. Improving the funded status of governmental pension plans cannot be accomplished solely by improving the accounting and financial reporting for pensions. Government officials must also be made aware of the need to conduct a proper analysis of pension costs to help ensure that their governments do not enter into pension plan arrangements that they cannot afford. In addition, those charged with governance must be aware of the need to and be committed to taking the steps necessary to fund their governments' pension plans. These steps will undoubtedly include improving operating efficiencies, raising taxes, and/or cutting services. Governmental accounting standards cannot and should not address these types of issues.

However, we believe that there are a number of components of the pension plan funding problem that can and should be addressed by changes in the governmental accounting standards. These include the lack of uniformity in how pension plans are accounted for (which results in a lack of comparability), the too frequent utilization of actuarial assumptions that are aggressive or otherwise inappropriate, the fact that the true cost of pension plans is currently not recorded and not adequately disclosed in the financial statements, and the funding crises that occur when significant investment losses attributable to poor economic conditions impair governments' ability to make the sharply-inflated annual required contributions to their pension plans in subsequent years.

It appears that many of the improvements in the accounting and financial reporting for pensions contemplated in the proposed standard were intended to and do address certain specific components of the plan funding problem. Requiring the use of the entry age normal actuarial cost method instead of permitting the use of six different actuarial cost methods will improve comparability among plans. The additional guidance provided in the proposed statement on the selection and use of actuarial assumptions will hopefully be more effective in preventing the use of aggressive or otherwise inappropriate assumptions. The net pension liability that the proposed statement requires to be recognized in accrual basis financial statements, along with the revised pension footnote disclosure requirements, are clearly intended to help ensure that pension expense and the liability for pensions are reflected more accurately in the financial statements. We believe that the most significant component of the pension plan funding problem, however, should be more fully addressed by the proposed standard. This problem is the funding crises that occur when substantial investment losses attributable to poor economic conditions impair governments' ability to make the increased annual required contributions in subsequent years.

Under GASB Statement #27, Accounting for Pension by State and Local Governmental Employers, the investment return assumption (discount rate) should be based on an estimated long-term investment yield for the plan (paragraph 10.c.). Under the proposed guidance, the long-term expected rate of return on plan investments is still to be used. It may seem appropriate to use a long-term expected rate of return given the long-term nature of the employee-employer relationship and the long-term investment strategy used to invest the plan assets (of most plans), but we suggest a more conservative approach. Even if the long-term expected rate of return is based on historical investment returns (which is not required by the proposed standard), there is no guarantee that the expected rate of return will be realized. Other accounting guidance in effect does not involve such aggressive accounting for contingencies. Under the Financial Accounting Standards Board's guidance on

accounting for contingencies (codification section 450-30-25, formerly FASB Statement #5, *Accounting for Contingencies*), gain contingencies are not reflected in financial statements. Of more importance, actual plan experience has demonstrated that in practice, the utilization of a long-term expected rate of return assumption just does not accomplish what was intended. ALGA recommends the guidance in this area be more conservative. If the methodology being used incorporated an adequate measure of conservatism, it would be less likely to result in underfunded pension plans, not more likely.

Under both the existing and proposed guidance, governments should never predict a negative investment return, although such a return may occur in any given year. While governments cannot be expected to predict when economic downturns (or other circumstances that will result in significant investment losses) will occur, the use of an investment return assumption that appropriately addresses the possibility of loss is essential given that investment experience directly impacts pension expense. Unforeseen decreases in plan net assets attributable to investment losses must be made up by increased plan contributions in future years, just as investment gains enable governments to reduce their pension plan contributions in future years (all other things being equal). Sharp increases in annual required contributions that occur as a result of significant investment losses actually reflect an erosion of a plan's ability to provide pension benefits that were previously funded. Consequently, such increases in annual required contributions support that pension expense was being under-reported in prior periods. Clearly, the use of a lower discount rate is more conservative, and would limit exposure to sharply increasing annual required contributions (and under-reporting of pension expense). We observed that the proposed standard does provide for the use of a high-quality municipal bond index rate (which is likely lower than the long-term expected rate of return for most plans at present) as the investment return assumption to the extent that plan assets are not available for long-term investment, but ALGA recommends a more conservative approach should be adopted.

Governments generally face unique and greater challenges in funding their pension plans than the private sector. Governments are especially vulnerable to economic downturns, as the need for services typically increases while the availability of economic resources to fund those services declines. The midst of an economic downturn is the worst time for governments to experience sharp increases in annual required pension plan contributions. A separate set of accounting standards was developed for governments and is being utilized to address the challenges imposed by the unique environment in which governments operate. To further the objective of establishing standards that address the specific needs of governments, the governmental accounting standards should be changed to address the challenges posed by the use methodology that permits the use of investment return assumptions that have generally proven to be excessive.

To that end, we believe that utilizing a discount rate that represents a risk-free rate of return assumption would be more appropriately conservative. Using a risk-free rate of return assumption would increase the actuarially-determined annual required contributions in the earlier plan years, which would result in an improved funded status of the plans if the required plan contributions were made. To the extent that investment returns on plan assets continue to exceed the risk-free rate of return assumption utilized, the actuarially-determined annual required plan contributions would decrease over time, minimizing the extent to which plans might become overfunded. This approach would be beneficial because well-funded pension plans are less susceptible to the impact of poor investment results than under-funded plans. In addition, there would be less incentive to invest pension plan assets in excessively risky investments in an attempt to make

up for lost ground when investment losses are incurred. While holding a portfolio of excessively risky investments could prove advantageous under favorable market conditions, doing so greatly increases governments' exposure to the risk of investment losses, which if incurred, significantly compound the funding problem.

While implementing the change we suggest would be quite unpopular and difficult for some governments to withstand given the current funded status of their pension plans, we believe that utilizing a risk-free return rate assumption is more appropriately conservative, would result in an improvement in the funded status of governmental pension plans, and is therefore in the long-term best interests of state and local government employers.

We observed that the proposed standard requires all actuarial assumptions to be made in conformity with Actuarial Standards of Practice issued by Actuarial Standards Board of the American Academy of Actuaries, which appears appropriate. However, we believe that if the proposed standard is issued as written, a valuable opportunity to communicate the importance of conservatism may be missed. At a minimum, we believe the standard should provide some explanation as to why adherence to the Actuarial Standards of Practice standards is perceived to be important.

In conclusion, ALGA believes the proposed standard will provide improvements in accounting and financial reporting for pensions. We suggest the guidance on investment return assumptions be made more conservative. In addition, we believe it would also be prudent to closely evaluate the impact of any issued pronouncements on the funded status of pension plans and make additional revisions to the guidance in the future, if appropriate.

Thank you for the opportunity to respond to the exposure draft. The accounting standards are important to our members, and we hope that our comments are helpful to you.

Respectfully Submitted,

Kristine Adams-Wannberg

Chair, Professional Issues Committee

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