



Classic Values, Innovative Advice

Letter of Comment No. 102  
File Reference No. 34-E  
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October 3, 2011

***VIA REGULAR MAIL***

Director of Research and Technical Activities  
Government Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

***Re: Pension Accounting and Financial Reporting by Employers***

To Whom It May Concern:

On June 27, 2011, the Government Accounting Standards Board (GASB or the Board) issued Exposure Drafts (EDs) related to pension accounting and financial reporting by governmental employers and governmental pension plans. The EDs would amend and replace current Statement of Governmental Accounting Standards No. 25 and No. 27. The EDs invited comments upon the matters discussed therein, and proposed questions for users of the financial information. Cheiron is submitting these comments in response to the invitation contained in the EDs.

Cheiron, Inc. is a full-service actuarial consulting firm with offices throughout the United States that was formed in 2002 as a spin-off from a larger, international firm. We help many of the nation's largest public sector pension plans manage financial risks. Our consultants have decades of experience with public sector pension plans.

**General Comments**

We appreciate that the EDs reflect the Board's thoughtful consideration of the issues surrounding the accounting for pension plan liabilities and expenses and the information presented by a broad array of stakeholders in response to the preliminary views published in the summer of 2010. The EDs represent a fundamental shift in the pension accounting and financial reporting with respect to government plans. The changes have the potential to significantly affect the reported financial position of a government.

We understand that the Board is most interested in hearing from the users of the financial information. Nevertheless, we believe that certain aspects of the EDs will pose technical and conceptual problems for the preparers and auditors of the pension and financial information. Accordingly, we have prepared responses to the specific issues below. In our responses, we make suggestions that we believe would improve the accuracy and understanding of the information. Because of the similarity and relationship between the two EDs, we have combined our comments into one letter on both drafts.



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### **Comments on Specific Issues**

#### **Issue – Projection to the Employer’s Financial Reporting Periods**

Under the ED for Statement 25, the financial statement of the plan is to include in the notes and required supplementary information (RSI), certain information with respect to the plan and the liability of the employer(s). This information includes classes of plan members and the number of members, the net pension liability (NPL) of the employer(s), and the changes in the net pension liability. The information in the notes and RSI is to be reported as of the end of the plan’s reporting period.

Under the ED for Statement 27, the financial statement of the employer is to include the net pension liability of the employer, as well as deferred outflows deferred inflows related to pension reported as of the end of the employer’s reporting period. The ED allows for the use of an update procedure to roll forward the results of an earlier valuation. However, the earlier valuation cannot be earlier than 24 months prior to the employer’s year end. The notes and RSI are to include additional information including classes of plan members and the number of members, the net pension liability of the employer(s), and the changes in the net pension liability. The information in the notes and RSI is to be reported as of the end of the employer’s reporting period.

The reporting of information as of the end of the employer’s reporting period will be problematic for both single employers and cost-sharing employers where the reporting period for the plan differs from the reporting period for the employer(s). One example of the problems the EDs pose is the need to report the number of members in each class at the employer’s reporting period end. Plan administrators generally gather membership information once a year as a by-product of the actuarial valuation for the year. The plan administrators are not going to be able to provide the numbers of members in each class of membership as of other dates without going to considerable expense. In the case of cost sharing employers with different reporting periods, the total of the number of members for each employer will not add up to the totals for the plan due to changes from the end of the plan’s reporting period to the employers’ reporting period end.

Another example is the changes in net pension liability. Where the employer’s reporting period differs from the plan’s reporting period, the changes in net pension liability may have to reflect values from two different reporting periods for the plan. The change in net pension liability reported at the end of the employer’s reporting period will therefore reflect a weighting of values from different reporting periods. Where there are multiple employers, with different reporting periods, the total for the employers will again not add to the total for the plan. Even with disclosure of the methodology, users will have a difficulty in reconciling employer figures to the figures for the plan.

There is a simpler alternative to reporting values at the end of the employer’s reporting period. That alternative is to use the values at the end of the plan’s reporting period ending with or within the employer’s reporting period. This will allow easy reconciliation where

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there are multiple employers and minimize any need to artificially project values to the employer's reporting period end. We believe there will not be any loss of value to users of the financial information.

**Issue – Impact upon Employer's Net Position**

The employer's statement of net position includes assets, deferred outflows, liabilities, and deferred inflows. For some employers (perhaps many), the pension plan will have a significant impact on their net position. However, under the Exposure Draft for Statement 27 (and the way we understand Statement 63) the pension disclosures keep all of the components that will appear in the employer's statement of net position separate. While the net pension liability is an important disclosure, it is also important to understand the total impact of the pension plan on the employer's net position. Consequently, we suggest that a schedule in the notes to the financial statements be added or amended to combine the net pension liability with the deferred inflows and outflows related to the pension plan to show the employer's net position related to pensions.

Using Illustration 2 as an example, such a disclosure might appear as follows:

	<b>12/31/X9</b>	<b>12/31/X8</b>
Total Pension Liability (TPL)	\$ 3,182,228	\$ 3,045,893
Plan Net Position	<u>2,512,987</u>	<u>2,283,333</u>
<b>Net Pension Liability</b>	<b>669,241</b>	<b>762,560</b>
Deferred Outflows	(229,559)	(310,538)
Deferred Inflows	<u>75,379</u>	<u>50,766</u>
<b>Employer's Net Position due to Pension</b>	<b>\$ 515,061</b>	<b>\$ 502,788</b>

**Issue - Description of Determination of Long-Term Expected Rate of Return**

The Exposure Drafts require the disclosure of "a description of how the long-term expected rate of return on plan investments was determined, including the assumed asset allocation of the portfolio, the best estimate of the long-term expected real rate of return for each major asset class, and whether the expected rates of return are presented as arithmetic or geometric means."

Actuarial Standards of Practice permit a variety of methods for developing an assumption for the expected return on plan assets, not all of which use the expected real rates of return for each asset class. In prescribing these specific disclosures, it is not clear if GASB intends to prescribe the methodology to be used to develop the assumed long-term expected rate of return or just to standardize the disclosure. If the expected return on plan assets is developed using a different method than implied by the prescribed disclosures, the disclosures could be misleading or confusing. Instead of prescribing specific disclosures, we encourage GASB to require detailed disclosures appropriate to the method used, and then use the methodology in

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the Exposure Draft only as an illustration. We also suggest that the illustration show or describe how the data shown is used to derive the final assumption.

For example, in the current Illustration 4 of the Exposure Draft of Statement 25, it appears that the geometric expected rate of return for each asset class is weighted by the target allocation for that asset class to develop the portfolio's expected real rate of return which is combined with the inflation assumption and rounded to the expected return of 7.75%. If this is the methodology, it should be described in detail. However, we would also note that, as stated, the example is technically incorrect. The arithmetic return for a portfolio is the weighted average of the arithmetic returns for each asset class, but to calculate the geometric return for the portfolio, the standard deviations of each asset class and the correlations between the assets classes must be taken into account. To get the nominal return, theoretically, the standard deviation of inflation and its correlation to the real returns of each of the asset classes should also be taken into account. Consequently, the analysis is often performed using nominal returns instead of real returns.

#### **Issue – Cost-Sharing Plans -- Determining the Employer's Proportion**

Liabilities, assets, expense, and contributions should be allocated to individual employers in a cost-sharing plan in a manner that reflects the fundamental nature of the cost-sharing structure of the plan. Paragraph 46 of the Exposure Draft of Statement 27 requires cost-sharing plans to calculate each employer's proportion of the collective plan based on the "employer's long-term contribution effort to the pension plan as compared to the total of all projected contributions of the employers." This proportion is used to calculate the employer's proportion of total pension liability, plan net position, net pension liability, pension expense, and actuarially calculated employer contributions. Because cost-sharing plans share costs in a variety of ways, the methodology prescribed by GASB may not reflect the cost-sharing structure of the plan resulting in misleading disclosures.

For example, a cost-sharing plan may charge each employer a different normal cost rate depending on their blend of safety and general employees (or employees in various tiers of benefits) while charging every employer the same unfunded actuarial liability (UAL) rate as a percentage of payroll. Effectively, then, the NPL is shared in proportion to payroll, but not in proportion to the contribution rate. The TPL and plan net position are not really allocated by employer. Consequently, an allocation of TPL, plan net position, and plan expense either all in proportion to contributions or all in proportion to payroll would be misleading.

Alternatively, a plan that is considered a cost-sharing plan may operate like an agent multiple-employer plan by tracking the assets and liabilities of each employer separately. This means that the employer's proportion of TPL, plan net position, NPL, and expense are determined separately for funding purposes in a way that may be different than the prescribed methodology. Consequently, the TPL, assets, and NPL allocated to the employer for accounting purposes may be different than the amounts shown for funding purposes even though there are no differences in assumptions or actuarial cost method.

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Given the diversity of cost-sharing structures, we suggest that Statement 27 allow the allocation of costs to individual employers in a manner consistent with the structure of the cost-sharing plan taking into account the manner in which contributions are determined for each employer.

#### **Issue – Calculation of Rates of Return**

In the ED of Statement 25, we believe that there is a technical problem in Illustration 1a on page 38 covering the time-weighted rate of return. The formula shown at the top of the "Period Return" column is shown as (b) divided by the sum of (a) plus (b). In this instance, (a) is the beginning fair value of investments and (b) is the investment income for the period. We believe that the correct formula would exclude (b) from the denominator so that the formula would become simply (b) divided by (a).

A simple example shows why the calculation illustrated is not correct. Assume assets of \$1,000 at the beginning of the period and investment return of \$100 (with no other additions or subtractions from the assets). One would expect the rate of return to be 10 percent (\$100 divided by \$1,000). However, applying the formula in the illustration on page 38, the result would be \$100 divided by \$1,100 or 9.1 percent.

While we appreciate the clarity that the illustrations depicting the calculation of rates of return, we are concerned that the illustrations will introduce unneeded complexities into the process. The Chartered Financial Analyst Institute, an investment professional body, has devoted resources to the accurate calculation of time-weighted returns, has issued Global Investment Performance Standards (GIPs), and has a web-site [www.gipsstandards.org](http://www.gipsstandards.org) which provides detailed guidance on the calculation of time-weighted returns. As this is an industry standard, a reference to GIPS methodology should be all that is required and Illustration 1a should merely point to the URL. It is highly likely that investment consultants will provide compliant return figures to their clients on a routine basis.

As an example of the complexities, the methodology appears to require a determination of plan asset values at the date of each cash flow. Such a determination of asset values is impractical for a large plan. There may be cash flows constantly into and out of a plan. Furthermore, an independent reviewer will not have enough data to reproduce the calculated rate of return. We suggest that the time-weighted return for the reporting period be determined consistent with the GIPs methodology without having to make determinations of the exact market value at the date of each cash flow. To do so may also create a significant additional administrative burden for smaller funds.

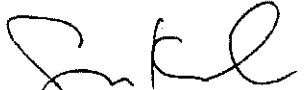
Similarly, we suggest that any money-weighted return be able to use approximations for the exact time that cash flows go in and out of a plan. For example, a plan that receives employee contributions within a few days after each pay period should have the flexibility to make a simplifying assumption as to the timing of those receipts rather than determine the time of each receipt.

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In summary, we believe that disclosure of rates of return for the plan's reporting period may be helpful but believe that the level of detail required exceeds the capabilities of the plans, and is not practicable. Therefore, we suggest that reference be made to existing standards along with disclosure of the methods used.

If the Board has any questions about these comments, feel free to contact the undersigned at 703-893-1456.

Sincerely,  
Cheiron



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