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PERSONAL COMMENTS

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Director of Research and Technical Activities
Project No. 34-E
Governmental Accounting Standard Board
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To: Director of Research and Technical Activities, Project No. 34

These comment are in response to the request for written comments on the Governmental Accounting Standard Board (GASB) Exposure Drafts – *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25* and *Accounting and Financial Reporting for Pension—an amendment of GASB Statement No. 27*.

These comments were originally prepared as part of comments to be submitted to the GASB by the Steering Committee of the Public Plans Community of the Conference of Consulting Actuaries (CCA) and may appear in some form in those comments as ultimately submitted. However they are being submitted here by the author as his comments as an individual, and they do not necessarily reflect the views of the CCA, the CCA’s members, or any employers of CCA members (including the author’s employer).

I would like to express my appreciation to the GASB and their project staff for their sustained efforts in striving to understand the complicated and interconnected issues surrounding accounting for public pensions. I also ask to be allowed to participate in the GASB’s hearing in San Francisco on October 13, 2011.

Major Issues and Concepts

To begin I would want to reference and endorse the Steering Committee’s comments on the Preliminary Views which commended the GASB on selecting a measurement approach consistent with the long-term nature of the pension obligation and the career long nature of the employment exchange. I concur with the Steering Committee’s strong endorsement of the use of a discount rate based on the expected long-

term return on investments and the use of the level service cost allocation method known as Entry Age Normal¹.

Also consistent with the Steering Committee's C comments on the Preliminary Views, my more critical comments and recommendations involve how changes in the pension obligation are translated into pension expense. The overriding issue that informs most of these comments is the practical consequences of GASB's decision to treat the annual allocation of the accounting cost of the pension obligation as separate from the funding of those obligations. While I believe that actuaries understand the rationale and are prepared to work with the result that annual pension expense will now be different from the annual contribution requirements, I would urge GASB to maintain a realistic appreciation of two general consequences

1. The need for the users of financial reports to be able to understand the relationship between these two measures of pension cost.
2. The need for pension plan and sponsors to be able to develop both accounting and funding information in ways that are reasonably practical and efficient.

These consequences require that even if pension expense and contributions are ultimately different they should still both be based on quantities that are practical to determine and that reflect the way pension costs and liabilities – whether accounting or funding – behave and evolve over time. Any differences should be well justified and straightforward to understand, and differences that are unnecessary or unduly burdensome should be avoided.

I would make bold to suggest to GASB that members of the actuarial profession are in a unique position in that we are the ones who will have to actually produce these new accounting measures and we are the ones who will be expected to explain how and why they differ from funding measures, which of course will still be needed. From that perspective I urge GASB to consider that, in general, if in the details of implementation there is an established actuarial practice that is reasonably consistent with the goals of financial reporting, then financial reporting should follow that established practice rather than inventing new procedures that are at best unnecessary and at worst unrealistically difficult to implement.

The comments you will receive from the Steering Committee will include substantial details on technical, multiple-employer and disclosure issues, all reflecting this practical perspective. In these comments I will address two higher level concepts that inform current actuarial practice for public pension plans. Both relate to the pooled nature of a pension plan, as distinct from more individually based means of providing compensation and benefits. The first relates to the measurement of assets and the second to

¹ Comment on terminology: the GASB may wish to consider going back to the Preliminary Views approach of calling this method the "Entry Age method". While the traditional name in actuarial practice is "Entry Age Normal" the word "Normal" conveys no practical purpose. There GASB has an opportunity to advance actuarial nomenclature.

the measurement of changes in liabilities. I will then discuss the substantial and complex compliance cost issues related to the new reporting requirements found in the Exposure Draft.

Asset Measures for the Net Pension Liability

In the Exposure Drafts the basic measure of the pension obligation is the Net Pension Liability (NPL) which is the difference between the Total Pension Liability (TPL) and the plan net position, which for clarity in this discussion I will call the Market Value of Assets (MVA). Because the NPL will be interpreted as the single and most basic measure of the pension obligation, I would ask GASB to reconsider the use of a NPL based on the MVA for the fundamental reason that the MVA based NPL does not provide a reliably consistent measure of the long-term nature of the pension obligation.

The problem with the MVA based NPL is that it is the difference between two quantities, only one of which behaves like a long-term obligation. The TPL is relatively stable, consistent with the long-term obligation it measures. But the MVA is subject to short term fluctuations that are in no way comparable to the TPL, nor are they representative of the variability in the underlying long-term net obligation. As a result the difference between TPL and MVA has all the volatility of the MVA and none of the long-term stability of the TPL.

I am aware that the Exposure Drafts address volatility in the MVA through a five year deferral of unexpected investment returns when determining pension expense, just as certain changes in the TPL are also subject to deferred recognition. I suggest that GASB recognize that asset volatility is so much greater than liability volatility that its deferral mechanism should be incorporated directly into the NPL, in order for the resulting NPL to better represent the long-term character of the unfunded pension obligation.

This would be accomplished by basing the NPL on an asset value determined as the MVA adjusted for the same five year deferral of investment gains and losses that is provided for in the Exposure Draft for determining pension expense. The resulting adjusted NPL would then be made up of two similarly consistent components and so would present a more reliably consistent and decision useful measure of the unfunded pension obligation.

Under the Exposure Draft, clearly this adjusted NPL could be calculated from information already provided. The difference is a reduced risk that the financial statement user will focus too narrowly on the volatile MVA based NPL. If this approach is not deemed acceptable I would propose that the deferred inflows and outflows of resources related to investments be displayed in the same schedule as the NPL. Under this approach a resulting adjusted NPL could also be included in the display².

Another aspect of comparing the TPL to the MVA involves the disclosure of funded ratios. Currently, there is only one funded ratio mentioned in the Exposure Drafts, one that compares the TPL to the plan

² It is my understanding that detailed schedules presenting this approach are included in the comments submitted by the American Academy of Actuaries, as developed by their Public Plans Subcommittee. I commend that discussion to GASB's attention.

net position (i.e., the MVA) which is proposed to be shown in the Required Supplementary Information (RSI). Comparing the TPL to only the MVA may be misleading for all the reasons just discussed. I would recommend showing the following two additional funded ratios which I believe will provide decision-useful information about the underlying relationship between assets and liabilities both from the accounting and funding perspectives.:

- a. TPL vs. Adjusted MVA (as described above) – added to *the Schedule of Net Pension Liability*,
- b. Funding Actuarial Accrued Liability vs. Funding Actuarial Value of Assets (AVA) – shown on the *Schedule of Employer Contributions*.

Pooling of Plan Experience

The Exposure Draft appropriately bases and measures the service cost and resulting TPL for each member on the projected benefits for that member, and then sums them over all participants to determine the total service cost and TPL for the plan. However there are some aspects of plan cost that result from the operation of the plan as a pooled vehicle for providing pension benefits. In particular, changes in TPL either due to demographic experience or assumption changes represent changes in the employers pooled obligation. Accounting for these on a person-by-person basis ignores the fact that the plan as a pooled vehicle allows the employer to provide the benefit to the member with cost efficiencies that would not be available through individual benefit arrangements. This leads to results that can misrepresent the actual experience of the plan and the resulting effect on the employer's financial obligation to the plan.

The clearest example involves the assumption as to when active members will retire. For this example, as is true for many public plans, we will assume that earlier retirements are more valuable than later retirements, so when members retire earlier than assumed the plan experiences a loss, while members who retire later than assumed generate gains. Suppose that at some age the plan assumes a 20% retirement rate and that one year, out of 10 members at that age, two retire and eight to not retire. Overall the plan has exactly met its retirement age assumption and so that year there is neither a gain nor a loss due to retirement.

In contrast, under the Exposure Draft approach the gain or loss is determined separately for each member, and then amortized (or not) based on the active or inactive status of the member. In our example the eight members who did not retire would generate a gain while the two who did retire would generate a loss. If we base amortization on status as of the valuation date, the gains would be partially deferred while the losses would be expensed immediately. This would probably result in a net expense charge even though the plan incurred no gain or loss due to retirement, that is, there was no unexpected change in the TPL due to retirement for the plan overall. As a result, here not only is the approach required under the Exposure Draft inconsistent with plan experience, it also requires calculations that are not required or even developed for any other purpose.

More generally I would recommend that GASB recognize that, unlike the expected allocation of service cost, the pooling of plan experience -- which is an essential determinant of the cost of services for benefits provided through the retirement plan -- does not end with the career of an individual member.

This leads to the conclusion that remeasurements of the cost of services (through gains and losses and through assumption changes) should be allocated to a period that generally represents the service of active members, without introducing an otherwise unnecessary separation between the experience of active and inactive members. It also indicates that the allocation period should represent the pooled future service of all active members, and not attempt (as in the weighted amortizations proposed in the Exposure Drafts) to reproduce an amortization of each individual active member's experience over that particular member's service

These are examples of situations where focusing on plan experience one member at a time leads to unexpected and arguably unintended results requiring calculations that have no other demonstrated usefulness. These are the situations where GASB should consider that already available measures and procedures would substantively and realistically accomplish their conceptual intent in a manner consistent with the long-term and pooled operation of the pension plan.

Cost of Compliance

Increased Compliance Costs. I appreciate the significant effort of the GASB to develop the proposed elements of the Exposure Drafts so as to reflect a "conceptual framework". However, in many areas this fresh start approach to the specific procedural and computational details would create an substantial and arguably unnecessary administrative burden which will be cost prohibitive to plan and/or the individual employers. While this is true for single employer and agent multiple employer plans it is especially true for cost-sharing multiple employer situations. I would urge GASB and project staff to work with public plan actuaries to identify alternative approaches that would reasonably comply with the conceptual intent but in a more practical and cost effective way.

As examples, three major elements that reflect significant complications and attendant additional costs are as follows:

(a) Situations where individual employers' fiscal year-ends do not align with the plan year-end will require not only additional actuarial calculations but, more significantly, multiple year-end asset valuations, including audits of those asset valuations.

(b) For cost-sharing plans, whatever method is used, the need to determine the individual employers' proportionate shares and the application of the proportionate share to all identified employer disclosures will generate unprecedented costs for these employers.

(c) The significant increase both in the notes to the financial statements and the Required Supplemental Information (RSI), both at the plan and employer level, will entail substantial additional cost.

Who is responsible for the increased cost of employer compliance? These significant additional costs raise a new issue. More exactly, they bring a new level of significance to the old issue of who bears the administrative responsibility and the cost for an employer's compliance with pension accounting standards. Under the current Statement No. 27 regimen, the information needed for the employer's financial statements is an immediate by-product of the actuarial valuations required and paid for by the plans. For that reason most employers do not need to separately retain either the plan's actuary or a

separate actuary to obtain this information, and the relatively slight cost of its production is borne by the plans.

Many of the new calculations required by the Exposure Drafts, including some of the more difficult to obtain results, would now be needed solely for the employer's financial reporting and are not otherwise needed for the operation of the plan. This will raise the legal question of whether the costs for such actuarial services can be paid out of the plan's assets, which in turn may raise IRS plan qualification issues. Furthermore, individual employers may not have access to the actuarial resources needed to provide such services, especially if there is reluctance to have the same actuary retained by both the employer and the plan. Finally, because the actuarial results would now be part of the audited financial statements (as opposed to the RSI) the employer's financial auditor may feel the need for independent actuarial capacity and review.

While at some level we as a profession might appreciate all this additional work, in fact we are concerned with the introduction of multiple, redundant and potentially conflicting actuarial functions into then operations of these plans. For that reason and consistent with my initial comments above, GASB should attempt wherever possible to have the details of pension expense calculations as consistent as possible with the actuarial calculations already required by the plans.

In summary, both the volume and the details of the new requirements in the Exposure Draft will dramatically increase the complexity and cost of producing employer financial reporting information. GASB should be certain that there is a correspondingly significant improvement in the practical decision usefulness of the information, so as to justify both the substantial additional costs and any requisite shift of those costs from the plan to the employers. In particular, to the extent that the Exposure Drafts require new and more complicated calculations, GASB should consider whether already available measures and procedures would provide equally useful information.