Letter of Comment No. 195 File Reference: 34-E Date Received; 10/12/11

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October 7, 2011

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This letter provides comments regarding GASB's Exposure Draft of Accounting and Financial Reporting for Pensions, Proposed Amendments to GASB Statements 25 and 27.

My objections to GASB's rules for calculating the funding status of public pension, and in particular to the discount rate these rules prescribe for discounting expected future benefit payments, are well documented in, among other places, *Journal of Finance, Journal of Pension Economics and Finance*, and *Journal of Economic Perspectives*. I consequently limit my comments here to a simple example that illustrates the problems inherent in both GASB's current and proposed methodologies, and a plea for setting aside the valuation argument and simply requiring plans to disclose the benefit payments they expect to make each year in the future, data that would be far more informative and transparent than any summary valuation of these expected payments.

First, consider two pension plans, "Plan A" and "Plan B." Each plan has a single, identical thirty five year old member, who plans to retire at the age of sixty five. Each plan intends to satisfy its obligations by buying an annuity in thirty years, at a cost of \$175,000. Plan A holds \$10,000 in stock, with an expected return of 10% per year. Plan B has the exact same stock position, but holds an additional \$10,000 in T-bills yielding 4% per year, the same yield as that found on high-quality municipal bonds.

Plan B is obviously \$10,000 better funded than Plan A—the two plans have the exact same liabilities and stock holdings, but Plan B holds an additional \$10,000 in liquid, marketable securities. Under GASB's current rules, however, Plan B is \$3,000 less well funded. Plan A is fully funded  $(175,000/1.1^{30} - 10,000 \approx 0)$ , while Plan B has a GASB underfunding of almost \$3,000  $(175,000/1.07^{30} - 20,000 \approx 3,000)$ .

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The proposed amendments to GASB Statements 25 and 27 do nothing to improve the quality of the plans' GASB calculated funding statuses. In fact, under the proposed new rules Plan B, the plan that is obviously \$10,000 better funded, would have to report that it was \$7,000 less well funded than Plan B, \$4,000 more than under current GASB rules. The proposed changes would have no impact on Plan A, which could still report that it was fully funded, while Plan B would be forced to recognize an unfunded liability of \$7,000 ((175,000 - \$20,000 x  $1.07^{30}$ )/  $1.04^{30} \approx 7,000$ ).

These results are complete nonsense. As long as GASB insists on a methodology that yields obviously incorrect results for the simplest examples, it will be impossible to take seriously GASB-calculated funding status in the real world. The methodology's failures in the examples above follow directly from GASB's insistence on tying the discount rate used to capitalize liabilities to the expected return on plan assets.

Finally, regardless of the Board's final decision regarding the discount rate used to capitalize expected benefit payments, the single most important change that the Board could make to the rules governing pension reporting and accounting would be to require that plans report the benefit payments that they expect to make each year in the future. This requirement would not impose any additional burden on plan sponsors, as they already calculate these payments in the course of calculating their total liabilities. Forcing plans to disclose this information would allow those that disagreed with prescribed procedure for capitalizing liabilities to asses plans' financial health using other methodologies, and truly further the Board's goal of developing "high-quality standards of accounting and financial reporting for state and local governments... [that] lead to information in financial reports that improves transparency, assists in assessing accountability, and is useful for making important decisions."

Sincerely,

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