

# State of Colorado



## DPA

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August 22, 2011

Director of Research and Technical Activities  
Project No. 34-E  
Governmental Accounting Standards Board  
401 Merritt 7, PO Box 5116  
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Dear Mr. Bean:

This letter is the Colorado Office of the State Controller's response to the Exposure Draft document titled Accounting and Financial Reporting for Pensions – an amendment of GASB Statement No. 27. Thank you for the opportunity to participate in this important due process.

As noted in the Preliminary Views document preceding this Exposure Draft, we have serious reservations about the Board's contention that funding for government pension plans can be completely separated from employer's financial accounting and reporting for such plans. The State of Colorado statutes and Constitution prohibit deficit spending. The State General Assembly has wisely chosen to rely on Generally Accepted Accounting Principles (GAAP) promulgated by GASB to determine whether deficits in current resources or cumulative resources (that is fund balances or net position) occur. The application of the concepts in this Exposure Draft to funds operated under the flow of economic resources and full accrual accounting (that is, accounting by internal service funds, enterprise funds, and fiduciary funds) will likely result in both statutory and constitutional violations by the State. The most likely remedy by the Colorado General Assembly will be to exempt these funds from the GAAP determination of Net Position for legal purposes. We are concerned that this will result in widening the gap between Colorado's legal/budgetary reporting and financial reporting under GAAP. That widening gap further degrades the comparability and accountability that are core concepts of GAAP.

Notwithstanding the foregoing, in general we believe that the Exposure Draft correctly applies the developments from Concept Statements No. 3 and No. 4. The proposed standards together will result in increased accountability for the current and cumulative prior period effects of the employment exchange implicit in providing governmental pensions.

Although we are in general agreement with the proposed standard we have the following concerns and requests for clarification that we ask the Board to address.

*“Good Government Starts Here”*

- Paragraph 34 in item e. requires disclosure of the effects of a 1 percentage point increase and 1 percentage point decrease in the discount rate. Item e. does not make it clear whether the 1 percentage point is applied at the level of the single rate that reflects the two underlying rates or at the level of the individual underlying rates. However, paragraph 56 does specify that the single rate equivalent to the application of the two underlying rates is the “discount rate for purposes of this statement.” We do not believe it is appropriate to apply the increase/decrease measurement at the single rate level. We believe the Board’s objective in this disclosure is to demonstrate the sensitivity of the Net Pension Liability to changes in the long-term investment rate of return which is to some extent under control of the pension fund investment manager through selection of investments that reflect changes in acceptable levels of risk. Conversely the high quality municipal bond index rate is in no way under the pension manager’s control. In addition, Illustration 1 demonstrates that the single rate is an imputed based on the present value of the benefits payments calculated using the underlying rates. As a result, the single rate is not directly applied to the benefits payments, but is strictly a mathematical calculation. In the current environment a one percentage point change in the long-term investment rate of return represents a plus or minus 12.5 percent change while a 1 percentage point change in high quality bond index represents approximately a 25 percent change. It should also be considered that the underlying rates are unlikely to move in the same direction (or in the same proportion) in an actual market change. For these reasons, we believe the Board should require this 1 percentage point sensitivity disclosure to be applied only to the underlying long-term investment rate of return with recalculation of the resulting single rate.
- Paragraph 42.a.(1) and 42.b.(1) and (2) and the related illustrations duplicate the presentation of total pension liability, the amount of plan net position, and the net pension liability. Paragraph 42.b.(1) and (2) only add the funded ratio, covered payroll, and the percent that net pension liability represents of covered payroll. We believe the three additional items required by 42.b.(1) and (2) should be presented in the schedule required by 42.a.(1). Schedule titles should be changed to reflect the consolidation of the information. This is an opportunity to remove a page from a large number of CAFRs across the country and cause no degradation in readability or usefulness of the information.
- Paragraph 46 uses the term “long-term contribution effort” without defining the term. Many factors affect the projection of contribution effort – the most difficult of which to estimate is the proportional mix. This estimate requires a cost sharing employer to not only estimate its own long-term employee count and wage growth, but to also have the same information from all other participants in the cost sharing multiple employer plan. That information may not be available to CAFR preparers. We believe GASB should define long-term as the average remaining service life of the employer’s employees and require CSME plans to accumulate and present the collective CSME participant estimates of long-term employee count and wage growth. This will avoid the inefficiencies inherent in each participant requesting the information from all other participants. In addition, the last sentence of paragraph 46 implies that use of the employer’s proportion established at the valuation date is only valid if no significant change occurs between the valuation date and the employer’s fiscal year end. The sentence does not explain how an individual employer would assess the significance of a proportion change or measure the change in the proportion when they may not be party to the events that caused the proportion to change. If the Board believes the proportion calculation will be the responsibility of

the plan, we believe that requirement should be included in the related plan reporting Exposure Draft.

- Paragraph 49 requires measurement of the CSME collective total pension liability at each participating employer's reporting period end, and paragraph 58 requires plan net position to be measured at the same point in time. Together they require calculation of the collective net pension liability at each CSME participants reporting period end. For large CSME plans having participants with various fiscal year ends, this could potentially require quarterly valuations. We believe the cost to implement the employer period end requirements of paragraphs 44 through 58 significantly exceed the users' benefit from the change in information that will result. Although professional judgment is allowed, we believe this requirement renders moot the provision for minimum valuation frequency of two years. The application of professional judgment in determining the need for a new actuarial valuation or roll forward treatment, which applies only to the collective total pension liability, is likely to result in wide diversity of application of the paragraph 49 requirements. In addition, it will potentially result in the matching of collective total liability that has not been updated against collective plan net position which is required to be valued at the employer's reporting period end. In order to avoid the cost of multiple valuations, it is possible that CSME reporting entities (or their legislative bodies) will change their fiscal year end dates (or the year end date of the CSME plan) to make the plan year end and the reporting entity year ends align. If that occurs in Colorado, we anticipate the CAFR issuance to take approximately two additional months. We believe the Board should allow the use of a valuation within six months of the reporting entity's fiscal year end. Pension plans are entities with long-term horizons that should not be required to respond with reporting changes to events inside a six month window.
- We believe clarification is needed for item d. in paragraph 57, which states, "The service costs of all pensions should be attributed through all assumed exit ages, through retirement". This text implies there is more than one assumed exit age. Item a. in paragraph 57 requires that attribution of present value of projected benefit payments be made on an individual employee-by-employee basis. If there is only one expected exit age per individual, the language in item d. is not compatible with the language in item a. If item d. is intended to address the probability weighing for various exit dates used in actuarial valuations, that should be explained or made clear in the standard. Since this proposed standard is directed to employers, we believe that actuarial processes should not be referenced without at least some explanation.
- We believe paragraph 58 should reference the related statement when it directs that valuation methods should be the same for the employer and the pension plan.
- Paragraph 59(b)(3) states, "All other changes in plan net position should be included in collective pension expense in the period of the change." (Projected earnings reduce pension expense and variances between projected and actual earnings are deferred and amortized as pension expense per 59(b)(1) and (2).) Employer contributions increase plan Net Position (as shown in Illustration 2 on page 119), but they are not included in the pension expense sample disclosure (as shown in Illustration 2 on page 120). We are unclear as to why the illustration seems inconsistent with paragraph 59(b)(3), and we believe that employer contributions should be shown as reduction of pension expense in that illustration. (See additional related comments regarding our ability to reconcile Pension Expense to the change in Net Position.

- Paragraph 70.a and 70.b.(1) through (3) and the related illustrations duplicate the presentation of total pension liability, the amount of plan net position, and the net pension liability. Paragraph 70.b. only adds the funded ratio, covered payroll, and the percent that net pension liability represents of covered payroll. We believe the three additional items required by 70.b. should be presented in the schedule required by 70.a. Schedule titles should be changed to reflect the consolidation of the information. This is an opportunity to remove a page from a large number of CAFRs across the country and cause no degradation in readability or usefulness of the information.
- Paragraph 90.a and 90.b.(1) through (3) and the related illustrations duplicate the presentation of total pension liability, the amount of plan net position, and the net pension liability. Paragraph 90.b. only adds the funded ratio, covered payroll, and the percent that net pension liability represents of covered payroll. We believe the three additional items required by 90.b. should be presented in the schedule required by 90.a. Schedule titles should be changed to reflect the consolidation of the information. This is an opportunity to remove a page from a large number of CAFRs across the country and cause no degradation in readability or usefulness of the information.
- The third sentence of Paragraph 96 requires recognition of a pension liability for a defined contribution plan for the difference between pension expense and actual contributions made. We believe the Board should specify the accounting and reporting requirements if the actual contribution exceeds the pension expense. If the Board believes the pension expense will always be at least the amount contributed, then the guidance should specifically address the amount by which the pension expense exceeds the actual contribution rather than citing the just the difference between those amounts.
- The arguments presented in paragraphs 157 and 158 of the Basis for Conclusions are unconvincing and concerning. The Board argues that valuation information could be one to two years out of date unless valuation information is required at the employers reporting date and cites the risk that plan net position can change significantly in a relatively short amount of time. We have seen that plan net position can actually change significantly from day to day and employer's financial reporting routinely takes approximately six months to complete. As a result, short term changes in plan net position cannot practicably be timely reported in employer's financial reporting regardless of what the standards require. However, the Board does have the opportunity to ensure that the pension accounting standards do not make financial reporting even later than it currently occurs, which is the likely result as governments align their financial reporting dates and pension valuation dates to avoid additional valuation or roll forward services costs. We believe the cost of rolling forward liability valuations and measuring net position will be little different than a requirement for annual valuations for small plans and will add significant cost for large multiple employer plans having multiple employer's year end dates. We believe the Board can accomplish its objectives and minimize adverse effects on timeliness of financial reporting by requiring the valuation date to be within six months of the employer's year end date. Audit costs associated with multiple valuations are an incremental cost and delay that add to the statement preparation challenges; the fact that they can be minimized through planning is little consolation. In ignoring the long-term and highly dynamic nature of pensions in deference to specific point-in-time valuations, the Board's position seems seriously out of touch with the realities of constricting government resources and expanding demands.

- The second and third sentence of paragraph 184 relates the Board's position that when resources are not projected to be sufficient to cover benefit payments the benefits liability takes on the attributes of traditional government debt. Consistent with the application of the long-term rate of return when net position is adequate to make benefit payments, we believe the discount rate should consistently be a function of how the liability is likely to be funded not of the nature of the liability. In tying the unfunded discount rate to the government bond index, the Board implies that an employer will follow one questionable management decision (failure to fund its pension plan) with another questionable management decision (borrowing to fund benefit payments). When net position is inadequate to pay benefits, we believe the Board should require governments to assume a pay-as-you-go discount rate such as the historical average of the government's short-term investment rate of return. In paragraph 196, the Board reinforces tying pension underfunding to borrowing with its requirement for the relevant index to be based on a 30 year bond maturity. Current events are demonstrating that citizens are more likely to demand pension benefit reductions or cuts in other government services than they are to support additional borrowing to fund pension payments.
- In paragraph 250 the Board indicates that it believes the process of projecting long-term contribution efforts in order to calculate the discount rate is a reasonable starting point for an employer to determine its proportionate share of a cost sharing multiple employer net pension liability. However, there is no requirement in this exposure draft or the related exposure draft for the CSME plan to communicate the underlying collective contributions that support its calculation of the discount rate used to attribute benefit costs to periods. Since the deferral and amortization of changes in proportionate share is likely to be an employer calculation rather than a plan actuary calculation, we believe there should be a formal mechanism for the CSME plan to communicate the collective long-term projected contributions of the CSME plan participants to those participants.
- Illustration 1 Table 3 on page 115. Given the Board's decision to use a high quality municipal market index rate to discount benefit payments when net position is inadequate to make those benefit payments, we believe that Columns C and E of Table 3 would need to reflect the interest costs implicit in that borrowing for years 26 through 99. Under the assumptions the Board is making regarding the pension liability taking on the attributes of regular governmental debt, the related interest costs of that debt add to the pension benefit cost. As previously noted, we do not believe that the municipal market index rate is appropriate for discounting benefit payments, and if the municipal market index rate were not used then the table would be correct as presented.
- On page 120, we believe the word "actual" in the second line of text following pension expense should instead be "active".
- On pages 119, 120, and 121, we are unable to reconcile the change in Net Pension Liability to the annual Pension Expense and the related deferrals of outflows and inflows. We believe that reconciliation is essential to understanding of this proposed standard for two reasons. First, the three schedules on these pages are the basis for recording a very large and material expense on our government's financial statements. The way in which the Net Pension Liability (plan based), Pension Expense (employer only), and deferred items (employer only) are presented implies that the normal rules of double entry booking are required to be followed. The combination of pension expense (since it appears to contain all related "revenue" items) and deferred pension expense should equal the change in Net Pension

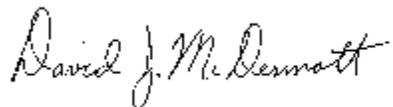
Liability. Second, any conceptual errors in the items listed in the Pension Expense or technical errors in calculating Pension Expense will result in permanent errors in an employer's financial statements that will not be subject to discovery. Therefore, we believe it is essential that the final standard clearly demonstrates how Pension Expense and deferred items will articulate with the plan level Net Pension liability. We could find no logical combination of the pension expense line items and deferred pension expense line items presented that produce articulation between those items and the Net Pension Liability presented. This paragraph is written in the context of Single Employer illustration; however, it applies equally to the situation where an employer participating in a cost sharing multiple employer plan must record its proportional share of the Net Pension liability even though the presentation of the detail (and necessary articulation) is not required of the CSME participating employer.

- As noted on page 3 of this document, paragraph 59(b)(3) states, "All other changes in plan net position should be included in collective pension expense in the period of the change." Given this statement it is unclear why the \$109,544 of Employer Contributions shown as an increase in Plan Net Position on page 119 are not presented as a reduction of Pension Expense on page 120. The inclusion of Projected Earnings on Plan Investments as a reduction of Pension Expense makes it very clear that the Board does not intend Pension Expense to be reported at the gross amount of the employment exchange, but rather that it be reduced by all amounts (per paragraph 59(b)(3)) by which the employer has provided for the future benefits through Plan Net Position. We believe that Employer Contributions clearly fall into this classification along with Employee Contributions and earnings on plan investments (projected and variances currently recognized or deferred). In order for Pension Expense (and related deferred items) to articulate to the Net Pension Liability (which is the total pension liability reduced by Plan Net Position) it cannot include pension costs that are already supported by amounts included in Plan Net Position. The above arguments are also consistent with the fact that the employer will have already reported in its financial statements the Employer Contribution as a portion of payroll expense. By virtue of its absence as a reduction of Pension Expense calculation on page 120, the same employer's contribution will be reported in both payroll expense and pension expense and result in inappropriate duplication on the employer's financial statements. Our inability to measure articulation of Pension Expense (current and deferred portions) to the change in Net Pension Liability from the illustration makes us additionally uncomfortable that all items theoretically necessary for that articulation are included in the Pension Expense illustration on page 120.
- The Total Pension Liability column of the Changes in Net Pension Liability Schedule on page 119 shows \$69,638 as the current period "Difference between expected and actual experience". That amount reconciles to the portion currently recognized (\$37,579) in the Pension Expense Schedule on page 120 plus the portion deferred (\$32,059) on the deferred inflows and outflows schedule on page 121. However, the footnote to the Pension Expense Schedule states that current period differenced between actual and expected experience in demographic factors is being amortized over the 11.5 year weighted average remaining service life; that would result in current period recognition of \$6,055 rather than \$37,579. The title shown in the Pension Expense Schedule is "Expensed portion of current-period differences between expected and actual experience in the total pension liability", which indicates that amortization layering should not be applicable to this line item and the correct amount should be \$6,055. Based on the text of the exposure draft, we

expect that all noninvestment related amortization layering would be presented in the line items titled "Recognition of beginning deferred outflows/inflows of resources as pension expense". Since this issue only changes the allocation between current recognition and deferral of an inflow, it should not have any impact on the articulation issue discussed in the previous two bullet points.

Thank you for the opportunity to participate in this important due process.

Sincerely,

A handwritten signature in black ink that reads "David J. McDermott". The signature is written in a cursive style with a large initial 'D'.

David J. McDermott, CPA  
Colorado State Controller