



AMERICAN ACADEMY *of* ACTUARIES

October 4, 2011

Director of Research and Technical Activities
Project No. E-34
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
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Re: Exposure Draft on *Pension Accounting and Financial Reporting by Employers*

Dear Mr. Bean:

The Academy of Actuaries¹ Public Plans Subcommittee appreciates the opportunity to submit comments on the Exposure Drafts of the amendments to GASB Statement Nos. 25 and 27. We recognize and appreciate the thorough process GASB has followed to develop these Exposure Drafts and the preliminary views documents, as well as the invitation to comment. Our comments focus on the extent to which we believe the Exposure Drafts do not meet, or could be enhanced to better meet, the objectives, concepts and principles established by GASB. In addition, we raise some practical considerations and a few technical comments.

Before addressing our specific comments, we would like to commend GASB for the general measurement approach selected. We concur with the use of the entry age normal cost method as recognizing the ongoing, career-long employment exchange between the employee and the employer and recognizing the cost of services as a level percentage of pay over an employee's career. This approach eliminates the use of some actuarial methods that defer a substantial portion of the costs for an individual employee until the later years of employment.

In the selection of an appropriate discount rate, we commend GASB for its recognition of the investment earnings generated by the pension fund. Use of the expected rate of return on assets to discount liabilities results in measures representing the expected funding cost to taxpayers (as opposed to the value to employees or a current market-consistent price).

In addition, we commend GASB for retaining a comparison of the actual employer contributions to the actuarially calculated employer contribution as we believe this comparison is critical for users of financial statements to be able to assess accountability and interperiod equity with respect to the funding of the pension benefits.

¹ The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Finally, we commend GASB for requiring increased disclosure on the development of the expected long-term return on assets. This assumption is critical to the measures developed and more complete disclosure of the development of that assumption is appropriate.

The following sections discuss our specific comments on various sections of the Exposure Drafts.

Employer's Net Position Related to Pensions

In order to be able to properly interpret and understand an employer's statement of net position, we believe it is essential to have a clear presentation of the pension plan's full impact on that position. Consequently, we suggest that a schedule in the notes to the financial statements be added or amended to include the employer's net position related to pensions.

As we understand the Statement of Net Position under GASB Statement No. 63, it consists of assets, deferred outflows, liabilities, and deferred inflows. Under the Exposure Draft of Statement No. 27, the Net Pension Liability is reported in the liability section, while the 5-year recognition of investment gains and losses and the amortization of liability changes are reported as a part of the deferred inflows and outflows. The total of these three items does not appear anywhere in the financial statements. As a result, users may inadvertently confuse the Net Pension Liability with the employer's net position related to pensions.

For example, in Illustration 2 of proposed Statement No. 27, the Net Pension Liability decreases from \$762,560 on 12/31/X8 to \$669,241 on 12/31/X9. But, it isn't clear that the impact of the pension plan on the employer's statement of net position changes from (\$502,788) on 12/31/X8 to (\$515,061) on 12/31/X9. To make these relationships clear, we suggest that the exhibits showing the Changes in Net Pension Liability and the Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions should be combined as shown in the exhibit below.

Changes in Employer's Statement of Net Position Related to Pensions

	Increase (Decrease)						Employer Net Position Related to Pensions (f) - (e)
	Total Pension Liability (a)	Plan Net Position (b)	Net Pension Liability (c)=(a)-(b)	Deferred Investment Experience (d)	Adjusted Net Pension Liability (e) = (c) - (d)	Deferred Liability Experience (f)	
Balances at 12/31/X8	\$ 3,045,893	\$ 2,283,333	\$ 762,560	\$ 177,276	\$ 585,284	\$ 82,496	\$ (502,788)
Changes for the year:							
Service cost	101,695	-	101,695	-	101,695	-	(101,695)
Interest	231,141	-	231,141	-	231,141	-	(231,141)
Benefit changes	-	-	-	-	-	-	-
Difference between expected and actual experience	(69,638)	-	(69,638)	-	(69,638)	(32,059)	37,579
Changes of assumptions	-	-	-	-	-	-	-
Contributions -- Employer	-	109,544	(109,544)	-	(109,544)	-	109,544
Contributions -- member	-	51,119	(51,119)	-	(51,119)	-	51,119
Net investment income	-	199,273	(199,273)	(16,804)	(182,469)	-	182,469
Refunds of contributions	(2,780)	(2,780)	-	-	-	-	-
Benefits paid	(124,083)	(124,083)	-	-	-	-	-
Plan administrative expenses	-	(3,427)	3,427	-	3,427	-	(3,427)
Other changes	-	8	(8)	-	(8)	-	8
Recognition of deferred items	-	-	-	(41,126)	41,126	(15,603)	(56,729)
Net changes	<u>136,335</u>	<u>229,654</u>	<u>(93,319)</u>	<u>(57,930)</u>	<u>(35,389)</u>	<u>(47,662)</u>	<u>(12,273)</u>
Balances at 12/31/X9	<u>\$ 3,182,228</u>	<u>\$ 2,512,987</u>	<u>\$ 669,241</u>	<u>\$ 119,346</u>	<u>\$ 549,895</u>	<u>\$ 34,834</u>	<u>\$ (515,061)</u>

In this example, we have separated the deferred items related to investment gains and losses from the deferred items related to liability gains and losses in order to isolate the often substantial period-to-period variability caused by investment performance compared to the relatively lower level of variability caused by liability gains and losses or other re-measurements.

This presentation also allows disclosure of what we have called an “Adjusted Net Pension Liability,” which provides a measure of the Net Pension Liability after adjusting for deferred investment gains and losses. Furthermore, by separating the asset and liability related deferral items this way, users will be better able to separately assess the reasonableness of the separate assumptions that relate to liabilities and assets.

Alternatively, the example below shows how the exhibit would look if the deferred outflows and deferred inflows were grouped together. We find this approach to be less useful for the user than the approach above. However, it is an improvement on the disclosure in the Exposure Draft as it clarifies the effect of the pension plan on the employer’s net position.

Changes in Employer's Statement of Net Position Related to Pensions

	Increase (Decrease)					Employer Net Position Related to Pensions (d)-(c)-(e)
	Total Pension Liability (a)	Plan Net Position (b)	Net Pension Liability (c)=(a)-(b)	Deferred Outflows (d)	Deferred Inflows (e)	
Balances at 12/31/X8	\$ 3,045,893	\$ 2,283,333	\$ 762,560	\$ 310,538	\$ 50,766	\$ (502,788)
Changes for the year:						
Service cost	101,695	-	101,695	-	-	(101,695)
Interest	231,141	-	231,141	-	-	(231,141)
Benefit changes	-	-	-	-	-	-
Difference between expected and actual experience	(69,638)	-	(69,638)	-	32,059	37,579
Changes of assumptions	-	-	-	-	-	-
Contributions -- Employer	-	109,544	(109,544)	-	-	109,544
Contributions -- member	-	51,119	(51,119)	-	-	51,119
Net investment income	-	199,273	(199,273)	-	16,804	182,469
Refunds of contributions	(2,780)	(2,780)	-	-	-	-
Benefits paid	(124,083)	(124,083)	-	-	-	-
Plan administrative expenses	-	(3,427)	3,427	-	-	(3,427)
Other changes	-	8	(8)	-	-	8
Recognition of deferred items	-	-	-	(80,979)	(24,250)	(56,729)
Net changes	<u>136,335</u>	<u>229,654</u>	<u>(93,319)</u>	<u>(80,979)</u>	<u>24,613</u>	<u>(12,273)</u>
Balances at 12/31/X9	<u>\$ 3,182,228</u>	<u>\$ 2,512,987</u>	<u>\$ 669,241</u>	<u>\$ 229,559</u>	<u>\$ 75,379</u>	<u>\$ (515,061)</u>

Either of these proposed exhibits would also make it clear that the change in the employer's net position related to pensions is equal to employer contributions less pension expense.

Actuarially Calculated Employer Contribution (ACEC)

The Exposure Drafts would require a 10-year schedule in the required supplementary information comparing actual employer contributions to actuarially calculated employer contributions,² "if an actuarially calculated contribution is determined." We appreciate the inclusion of this schedule as it provides vital information on accountability related to the funding of the pension plan, but we are deeply concerned about requiring the schedule only **if** an ACEC is determined.

A number of studies have shown a high correlation between the funded status of a pension plan and whether or not the annual required contribution had been contributed on a regular basis. We understand GASB's discomfort with setting a funding standard, so we support the change from the ARC to the ACEC. However, by making the disclosure of the ACEC conditional, there is an incentive for any plan that doesn't contribute an actuarially sufficient amount to not calculate an ACEC and thereby avoid accountability. Therefore, we believe the schedule comparing actual contributions to an ACEC should be required for all plans.

It may be that GASB is concerned about requiring additional work that would otherwise not be required. However, in this case, the disclosure is so essential to enabling financial statement users to assess whether or not the plan has been following a reasonable funding regimen that the additional work required, if any, is warranted.

² Note that we also recommend that the standard should refer to this as an actuarially "determined" employer contribution (ADEC) in order to clarify that there is much more involved in the development of an actuarially based contribution than just the resulting calculations.

If GASB is not persuaded that any additional effort required to have all plans produce this schedule is warranted, we suggest that plans that do not determine an ACEC be required to produce the schedule using the following components of pension expense in place of the ACEC:

- Service cost
- Interest on the total pension liability
- Projected earnings on plan investments
- Member contributions
- Administrative expenses

Conceptually, these components of pension expense represent the employer's cost of benefits and administrative expenses attributed to the current year by the entry age normal cost method plus, in most cases, net interest on the unfunded actuarial liability. Any contribution policy intended to fully fund the plan would need to be sufficient to provide for at least this amount over time. Hence, it can be used as a rough proxy for an ACEC. Any employer using this proxy should be required to disclose that they are using the proxy instead of an ACEC.

Interpretation of Pension Expense

Historically, the pension expense has been tied closely to the Annual Required Contribution (ARC) and deviations in actual contributions from the ARC resulted in a liability or an asset, the net pension obligation (NPO), on the employer's balance sheet. The appropriate interpretations of these items were very clear: the ARC represented the cost of services for the year in terms of a funding strategy and the NPO represented the cumulative deviation of actual contributions from the ARC.

Under the Exposure Drafts, the structure of the accounting has been reversed. The NPL is now disclosed on the balance sheet, and the combination of the deferred items, pension expense, and actual employer contributions adds up to the change in the NPL. While it is clear how to interpret the NPL, it is not immediately clear what the new pension expense represents.

Presumably, the pension expense is intended to represent an accounting allocation of the cost of services to a particular year. Yet, it is difficult, for example, to understand how the impact of changing the mortality assumption on retirees represents a cost of services in the year the assumption change is adopted. It is, instead, a re-measurement of a prior cost of services.

We have already noticed some confusion about the interpretation of pension expense as some knowledgeable commentators have suggested that while not requiring contributions in that amount, the pension expense still represents an ideal contribution amount. This confusion may be cleared up over time, but it would be helpful if GASB would include in the final standard a discussion of what the pension expense is intended to represent and how the new expense measure accomplishes this intent. Without such a discussion, the

pension expense will be interpreted in a variety of ways that may be inaccurate and potentially misleading. Users of the financial statements may make decisions based on these incorrect interpretations.

The presentation of the components of pension expense in the notes could also help with its interpretation by users of the financial statements. For example, the pension expense could be broken into subcomponents representing categories such as operating activities, financing activities, recognition of investment gains and losses, and recognition of liability gains and losses or other re-measurements. Again using Illustration 2, this approach might result in an exhibit such as the following.

Pension Expense

Operating Activities

Service cost	101,695	
Current-period benefit changes	-	
Member contributions	(51,119)	
Administrative expenses	3,427	
Total		54,003

Financing Activities

Interest on the total pension liability	231,141	
Projected earnings on plan investments	(178,268)	
Total		52,873

Recognition of Investment (Gains) or Losses

Current year (gains) or losses	(4,201)	
Prior years (gains) or losses	41,126	
Total		36,925

Recognition of Liability (Gains) or Losses

Items recognized immediately	(32,236)	
<u>Deferred items:</u>		
Current year (gains) or losses - active members	(5,343)	
Prior years (gains) or losses - active members	(320)	
Current year assumption changes - active members	-	
Prior years assumption changes - active members	15,915	
Total		(21,984)

Total Pension Expense		<u>121,817</u>
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With this organization, we believe it will be much easier for users of the financial statements to make appropriate interpretations of the pension expense.

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.”

While we strongly support enhanced disclosures of the development of this assumption, the required disclosures should be flexible enough to accommodate the wide variety of

methods used in practice that are consistent with Actuarial Standards of Practice. Not all of these methods use the expected real rates of return for each asset class. Instead of prescribing these specific disclosures, we encourage GASB to require detailed disclosures appropriate to the method used, and then use the methodology in the Exposure Drafts only as an illustration. We also suggest that the illustration show or describe how the expected real rates of return are 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, in that the weighted average of the geometric returns for each asset class ignores the effects of portfolio diversification and rebalancing to target allocations, and thus does not fully capture the expected growth in the asset portfolio.

Actuarial Standards Board

In the Exposure Drafts, there are references to the "Actuarial Standards Board of the American Academy of Actuaries." Please note that the Actuarial Standards Board is an independent organization that develops and adopts Actuarial Standards of Practice. Consequently, references in the Exposure Drafts to the "Actuarial Standards Board of the American Academy of Actuaries" should be corrected to simply the "Actuarial Standards Board."

Sensitivity of the Net Pension Liability

The Exposure Drafts require the disclosure of the sensitivity of the net pension liability to the discount rate assumption. The primary value of this disclosure is to convey the sensitivity of the TPL and the leverage of this sensitivity in determining the NPL. Consequently, we would encourage GASB to include the TPL, plan net position, and the NPL in this disclosure so that users will better understand how the components of the NPL are sensitive to the changes in the discount rate. Also, the current Illustration 4 of the Exposure Draft of Statement 25 is unrealistic. A more realistic and comprehensive example, assuming a 15% change in TPL for a 1% change in discount rate, would be as follows:

	1% Decrease (6.75%)	Current Assumption (7.75%)	1% Increase (8.75%)
Total pension liability	\$ 45,427,821	\$ 39,502,453	\$ 34,349,959
Plan net position	<u>(35,979,370)</u>	<u>(35,979,370)</u>	<u>(35,979,370)</u>
Net pension liability	<u>\$ 9,448,451</u>	<u>\$ 3,523,083</u>	<u>\$ (1,629,411)</u>

Determining the Employer's Proportion

Paragraph 46 of the Exposure Draft of Statement 25 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.” Cost-sharing plans share costs in a variety of ways. As a result, this methodology for determining the employer’s proportion may be appropriate for some plans and inappropriate for others.

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 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. This is an example of how the components of plan expense can be shared differently depending on the component. 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.

As another example, a plan that is considered a cost-sharing plan under the definition proposed in paragraph 11 of the Exposure Draft of Statement 25 (i.e., no legal separation of the assets of each employer) may in fact operate like an agent multiple employer plan by tracking the assets and liabilities of each employer. This means that the employer’s proportion of TPL, plan net position, NPL, and expense are in fact already determined separately, and in a way that may be different than the proportion currently described in paragraph 46.

Given the wide variety of cost-sharing plans and the variety of ways those plans share costs, we suggest that the Exposure Draft be amended to provide the flexibility to allocate costs to individual employers in a manner consistent with the way those costs are actually shared in the cost-sharing plan. The appropriate note disclosures on an employer level may also need to change depending on the cost-sharing methodology.

Employer Year-End Disclosures

All of the reporting described in the Exposure Draft for Statement 27 is as of the employer’s fiscal year end. From a theoretical basis, this requirement appears reasonable. However, for many large multiple employer pension plans (agent and cost-sharing) the requirements of providing this information could be unrealistically onerous. Some plans would be required to project liabilities, value and report assets, perform the necessary accounting calculations, and develop disclosure exhibits for the entire plan as of 12 different dates each year. Although clearly a windfall for actuaries, auditors and other consultants involved in the process, it is not clear that the benefits of calculations as of each employer’s fiscal year-end are worth the additional expense when compared to other alternatives.

We suggest the GASB consider some alternatives such as the following to ease the administrative burden:

- Clarify that the determination of significant events in assessing the appropriateness of roll forward techniques is to be done on a plan-wide basis and not an employer basis. The employer could add a discussion of significant employer events as part of their

financial statements, but many events that may be significant for an individual employer may not even be known to the actuary or the plan until the next valuation.

- Consider using reporting and disclosure amounts calculated as of a single date for multiple employer plans. The single date could be the plan year end or the largest employer's fiscal year end.
- Consider allowing the projection of plan net position from the plan's year end to the employer's year end along with the disclosure of the projection.

These alternatives clearly involve a compromise in the date specific accuracy of the amounts reported. However, they will reasonably and consistently show the employer information over time and also will both significantly reduce administrative burdens and shorten the time required to produce employer financial statements.

We appreciate the opportunity to submit comments on the Exposure Drafts of Statements 25 and 27, and we would be happy to clarify our comments or provide other technical assistance as GASB deliberates over the final versions of these Statements. If you have any questions or need further information, please contact Jessica Thomas, Senior Pension Policy Analyst (Thomas@actuary.org; 202/223-8196).

Sincerely,



William R. Hallmark, ASA, FCA, EA, MAAA
Chair, Public Plans Subcommittee
American Academy of Actuaries