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Re: Proposed Statement, "Accounting and Financial Reporting for Pensions – an amendment of GASB Statement No. 27"

Dear Mr. Bean:

We appreciate the opportunity to comment on the Proposed Statement of the GASB (the Board), "*Accounting and Financial Reporting for Pensions – an amendment of GASB Statement No. 27.*" We fully support the Board's efforts to reexamine its current pension accounting and financial reporting standards. We agree with the Board's view that an employer remains primarily responsible for the portion of its pension liability to employees in excess of the plan net position available for pension benefits. We also agree with the Board that, to the extent that plan net position has been accumulated, the pension plan is primarily responsible, and the employer becomes secondarily responsible for the obligation. We also maintain that the employer's pension liability meets the definition of a liability; that the pension liability is measureable with sufficient reliability; and that the projection of benefit payments should include cost of living adjustments (COLAs), ad hoc COLAs, future salary increases and future service credits.

That being said, while we support many of the overall tenets of the Board's Proposed Statement, we do have a number of concerns relating to this Proposed Statement that we believe should be addressed prior to its final issuance. These concerns are addressed in the following sections of this letter.

Scope (paragraph 4): The Proposed Statement would apply only to pension plans administered through a qualified trust (as defined). We believe the Proposed Statement should also apply to pension plans administered outside of a trust. While we understand that the Board believes there potentially are additional measurement considerations for plans not administered through a qualified trust, it is not clear to us which additional considerations might exist that would support a different measurement objective. In our view, consistent accounting for all pension plans sponsored by state and local government employers will improve financial reporting.

In addition, we support the Board's current project on other postemployment benefit accounting and financial reporting. We encourage the Board to complete this project as soon as possible.

Timing and frequency of measurement (paragraph 18): While we support the Board's proposal to require measurement of the total pension liability as of the end of the employer's reporting period, we believe the Board should require, instead of encourage, actuarial valuations to be performed annually. Even minor changes to the terms of a plan, as well as participant data, can have a significant effect on the measurement of the total pension liability for a plan with a large number of participants. The use of roll forward techniques, as would be required by the Proposed Statement, may not accurately reflect the financial reporting effects of these events. Significant changes in the employer's net pension liability that are identified in a financial reporting period when an actuarial valuation is performed ("true-up adjustments") may be the result of events that did not occur during the reporting period and were not previously captured by the roll forward techniques.

We understand that requiring annual actuarial valuations would affect the timeliness of financial statements as well as costs, but, in our view, the detailed estimation process underlying an actuarial valuation produces a more useful measure of the employer's total pension liability than the approximation of the total pension liability provided by roll forward techniques. In addition, we believe the use of roll forward techniques, as proposed, are appropriate only in situations when the use of the technique will not result in a materially different financial reporting result than the information provided by an actuarial valuation. Accordingly, material variances between the measurement of the obligation using a roll forward technique and resulting from an actuarial valuation may raise questions in hindsight about whether roll forward techniques were properly performed.

If the Board decides to retain the proposed biannual valuation requirement (instead of annual), we suggest that the final standard include additional guidance on the use of roll forward techniques. We agree with the Board that the determination of the scope and timing of roll forward techniques involves judgment, but we think judgments would be applied more consistently if the Board provided guidance with respect to matters including the following:

- ▶ The objective of performing a roll forward technique
- ▶ The minimum categories of participant data that should be rolled forward (e.g., new participants, changes in marital status, death or disability events, etc.)
- ▶ How changes in the plan's benefit formula should be rolled forward (or clarify that changes in the plan's benefit formula require measurement by an actuarial valuation)

In addition, the final standard should clarify that the assumptions used to measure the total pension liability are determined as of the end of the employer's reporting period (i.e., they are not rolled forward).

Lastly, we recommend the Board clarify how the final standard will apply to early retirement incentives that are considered termination benefits that affect an employer's defined benefit pension obligation. Currently, Statement 47, "Accounting for Termination Benefits," paragraph 17, refers to the existing pension guidance for employers in Statement 27, "Accounting for Pensions by State and Local Government Employers" (which is being superseded by the Proposed Statement) for the effect of a termination benefit on an employer's defined benefit pension obligation. It is not clear how early retirement incentives that are considered termination benefits will affect an employer's pension accounting under the Proposed Statement.

Measurement of the total pension liability (paragraph 20): We recommend that the final standard clarify when changes in plan provisions should be incorporated into the measurement of the total pension liability. Specifically, we believe that changes in laws should be included in the measurement when the law has been enacted, and other changes in plan provisions should be included when they are approved (not when they become effective), consistent with the accounting under the FASB's Accounting Standards Codification (ASC) Topic 715-30, *Compensation- Retirement Benefits*. In our view, it is important to address this point in the final standard so that changes in plan provisions are accounted for consistently.

Discount rate (paragraphs 22 - 25): We agree with the Proposed Statement that the development of the discount rate should be based on the expected future benefit payments, as determined by the actuarial method used to estimate the benefit obligation. We disagree with the remainder of the Board's discount rate proposals in paragraphs 22 - 25 of the Proposed Statement in that: (1) many proposed elements for developing the discount rate are unreasonably subjective, which would reduce comparability of the obligations between plans, and (2) the method is unnecessarily complicated and would reduce financial statement users' ability to understand the benefit obligation.

We believe the Board should require the use of a single method for developing the discount rate, resulting in a benefit obligation that more closely reflects market value. The following paragraphs more fully describe our concerns with the Board's discount rate proposal and our related recommendations.

Subjectivity reduces comparability

Under the Board's proposal, the first component of the discount rate method is the determination of the extent to which the expected future benefit payments can be made with the sum of:

- ▶ Current assets
- ▶ Projected future contributions (including all employee and employer contributions except the portion of employer contributions for future service costs)
- ▶ Investment earnings on all of the above

If the sum of these items is sufficient to cover expected future benefit payments, this portion of the benefit obligation is discounted using the long-term expected rate of return on pension plan investments that are expected to be used to finance the pension payments.

Projected future contributions in this proposed model are not based on objective criteria. In our view, allowing employers to take credit for future contributions may potentially lead to abuse because optimistic projections of the timing and amount of future contributions could inflate the discount rate (and reduce the benefit obligation). For example, if the plan net position is projected to be sufficient to cover projected benefit payments, the employer is required to discount the benefit obligation using the long-term expected rate of return on pension plan investments. This rate may be higher than the index rate that is required to be used when plan net position is not sufficient to cover projected benefit payments. In addition, we believe it is too difficult to assess the probability of "planned" future contributions.

Future asset growth is also a highly subjective measure. Paragraph 19 says the development of assumptions should conform to Actuarial Standards of Practice (ASOP). Section 2.1 of ASOP 27, which guides the development of economic assumptions, defines the “Best-Estimate Range” for assumptions to be “the narrowest range within which the actuary reasonably anticipates that the actual results, compounded over the measurement period, are more likely than not to fall.” In practice, this language is interpreted by many actuaries to be a range of returns from the 25th percentile of expected returns to the 75th percentile of expected returns. The choice of any assumption within this range could be viewed as meeting the standard. Please note that at the top of this range there is only a 25% likelihood of the assets meeting this level of return in the long term. In our view, based on this high level of subjectivity, we do not recommend including investment earnings in the development of the discount rate.

The second component of the discount rate method is to identify expected future benefit payments that are not covered by the sum of items listed above. These excess amounts are required to be discounted using an index rate for a 30-year tax-exempt municipal bond rated AA/Aa or higher. If the Board retains this requirement in the final standard, we suggest the description of the index rate be clarified because it could be interpreted to mean the yield-to-maturity, a spot rate yield or a forward rate. Further, the municipal bond index rate is required to be used for assets that are held for only a short time. Determining what constitutes a “short time” is also subjective and requires clarification to improve comparability between employers.

The Board's proposed approach to the discount rate would not improve comparability in reporting. Based on the proposed discount rate method, plan sponsors with similar anticipated benefits would have different obligations due to differences in:

- ▶ Levels of current funding
- ▶ Investment mix
- ▶ Expectations of future asset growth for any particular class of asset
- ▶ Expected future contributions
- ▶ Interpretations of the municipal bond rate

All of these factors can cause differences in the assumed discount rates, which, on a combined basis, can be significant. In addition, the Board's proposal could cause some employers to take on additional levels of risk in their funded plans to achieve a higher discount rate and lower level of obligation.

Complexity affects usefulness of financial statements

The discount rate is a key driver in the development of an employer's benefit obligation. Financial statement users will need to have a clear understanding of how the discount rate has been determined to understand an employer's obligation for pension benefits. As described above, there are a large number of judgments and interpretations that need to be made under the proposed model to arrive at the discount rate. The financial statement user would need to know not only the rules for establishing

the discount rate, but also the employer's interpretations of those rules and ultimately the extent to which the rate was based on a rate associated with asset mix and asset growth and the extent to which it was based on a municipal bond rate. This complexity obscures the information about the estimated timing and amount of future cash flows associated with pension benefits.

Recommendation

We recommend discounting the employer's benefit obligation using high-quality fixed income investments for which the maturity of the investments represents the anticipated time frame over which benefit payments will be made. A defined benefit obligation represents the promise made to participants in the plan by the entity sponsoring the plan. Although actual benefit payments may change over time, they are generally well-defined amounts. The obligation that represents the value of that promise should reflect the risk that an entity may default on that promise. It is our understanding that these promises have a low risk of default and as such should be discounted at a rate that has a similar low risk. We suggest that the discount rate be determined from yields on high-quality fixed income investments, rather than municipal bonds, because the plan would not avail itself of the tax benefit inherent in the pricing of a municipal bond.

Actuarial method (paragraph 26): We agree with the Board's preliminary conclusion of using a single actuarial method for determining an employer's benefit obligation and annual pension expense. The use of a single method would improve the comparability of the pension costs from employer to employer. The individual entry age actuarial cost method, as proposed, is a method that attributes the cost for each participant as a level percentage of that person's compensation over his or her career. Although this method provides a consistent level of annual pension expense as a percentage of compensation over a participant's career, we recommend using the projected unit credit actuarial cost method (PUCM), because the measurement of an employer's benefit obligation better reflects the manner in which benefits are accrued. The next two paragraphs provide examples that illustrate this point.

Paragraphs 26.c. and 26.d. identify the beginning and the end of the attribution period. Under certain plan designs, the individual entry age actuarial cost method can attribute costs to years in which there are no benefit accruals. Consider a plan that provides 2% of final average compensation for the first 20 years of a person's career. Changes in estimated retirement benefits after the 20th year of service relate only to increases in final average compensation. If the assumed retirement age extends beyond a participant's 20th year, the individual entry age actuarial cost method would continue to attribute service cost to these years. Continuing this example, benefit costs for a participant who begins earning pension benefits at age 25 and is expected to retire at age 65 will be attributed equally over the participant's anticipated 40 year career, although the last 20 years of employment provide an increase in retirement benefits based only on increases in compensation. This illustrates that the individual entry age actuarial cost method does not recognize the manner in which benefits are actually earned, but instead focuses on anticipated career employment. Using the same example above, benefit accruals under the projected unit credit method would occur for the first 20 years only (those accruals include an estimate of benefits based on a participant's final average compensation), matching the service period over which benefits are earned.

As an additional example, consider an amendment to the plan described in the prior example that reduces the benefit accrual for service after 10 years and up to the 20th year to 1% of compensation, but does not adjust the benefit accrual for the first 10 years of service. Under the individual entry age actuarial cost method, an employer would reduce the pension obligation for a plan participant that had previously provided 8 years of service when the plan is amended, even though the pension benefits earned in that person's first 8 years do not change. Under the projected unit credit method, the obligation for this participant would not change, since the benefit accrual for those years did not change. The reduction for years 10 through 20 would be incorporated into the service costs for those years.

These examples illustrate how the individual entry age actuarial cost method may not always attribute benefit costs to the periods of service provided in exchange for those benefits. Accordingly, we disagree with the Board's selection of the individual entry age actuarial cost method and prefer a method that more closely attributes costs to the period of time over which the benefits are earned, such as the PUCM. Although the PUCM does not produce a service cost that will be a level percentage of compensation for the participants, it better attributes costs to years of service in a manner that reflects the benefits earned during those years of service. As such, the liability recorded on the statement of net position is a better reflection of the employer's benefit obligation.

Changes in the total pension liability (paragraph 28): The Proposed Statement would require the increase (decrease) in the total pension liability from plan amendments to be recorded as an expense (income) in the period the plan change occurs. The Proposed Statement does not distinguish between increases in benefits to vested or unvested participants. While we agree that the cost of benefit improvements to vested participants should be recorded immediately as part of pension expense, we do not agree that benefit improvements to unvested participants should be recorded immediately as expense, even if those benefits are attributable to prior service. Recording the cost of those benefit improvements as a deferred outflow, with recognition as a component of pension expense during the remaining vesting period will better reflect the cost of services provided by employees in those reporting periods.

Also, the Proposed Statement's approach to defer both actuarial and asset gains and losses and record them in income over a closed period seems to add unnecessary complexity that does not have strong conceptual merit. We would support the use of a simple averaging method, rather than the closed-period weighted average approach. Additionally, while we do not object to the requirement to defer the gains and losses over future periods, the Proposed Statement does not appear to permit recognition of gains and losses over a shorter period, including immediately recognizing them in the period incurred. We generally think that recognizing gains and losses in income in the period they arise is preferable, so we believe an accounting policy election to more rapidly recognize gains and losses should be available to state and local government employers (similar to ASC 715-30).

Lastly, the accounting for actuarial gains and losses differs for active and inactive participants. Specifically, for inactive participants, gains and losses are required to be recorded as expense in the period incurred, and gains and losses for active participants are deferred and recognized in income in future periods. We encourage the Board to define an "inactive" or "active" participant in the final standard because the classification may not always be clear. For example, employees fully vested in pension benefits may still be actively working at the state or local government employer. In this case,

some employers may consider the employee to be “inactive” for purposes of the pension plan because pension benefits are no longer being earned. Other employers may consider the employee to be “active” because the individual is still actively working at the employer.

Cost-sharing employers (paragraphs 46, 60, 61): We agree with the Proposed Statement’s requirement for each cost-sharing employer to record its proportionate share of the collective (all employers) net pension liability, collective pension expense and collective deferred outflows and inflows of resources (the elements) for a pension plan. However, we are concerned that the determination of a cost-sharing employer’s proportionate share based on projected future contributions as compared to the total of all projected employer contributions would be difficult to apply. For example, even though an employer may have the information to project its future contributions for a period of time, an employer may not be able to obtain projected contributions for all of the other employers participating in the cost-sharing plan. Even if an employer obtains the projected contributions for other employers from the cost-sharing plan, those projections may not have been prepared on a consistent basis, which decreases the relevance of projected contributions as a proxy for a cost-sharing employer’s obligation to its employees.

We encourage the Board to require a more objective allocation method that can be applied consistently by all employers in a cost-sharing plan. In our view, an appropriate allocation methodology would reflect an employer’s proportionate share of the pension obligation at the reporting date based on known (instead of projected) participant or plan information (e.g., covered payroll). Changes in the employer’s proportionate share that do not relate to changes in the pension obligation (e.g., an increase or decrease in an employer’s covered payroll as a percentage of covered payroll for all employers) would be recorded in income instead of deferred and recognized in income in future periods.

Lack of information necessary for allocation of collective pension elements in cost-sharing multiple-employer plan financial statements to participating employers: As stated previously, we agree that cost-sharing employers should recognize their proportionate share of the pension elements. However, we have significant concerns that the Board’s proposal does not address how the participating employers would obtain sufficient, reliable and verifiable information on which to base the reporting of their proportionate share of the collective net pension liability, collective pension expense and collective deferred outflows of resources and collective deferred inflows of resources related to pensions. There are a range of potential solutions to this problem. We believe the Board is in a position to alleviate some of the burden of facilitating the exchange of reliable and verifiable information between plans and employers by establishing requirements for the disclosure of the required components of the cost-sharing plan’s financial statements in a re-exposure of the Proposed Statement, “*Financial Reporting for Pension Plans – an amendment of GASB Statement No. 25.*” The most effective way for the Board to address this issue would be to require a statement of the allocation basis for each employer as a basic financial statement or a required note disclosure for each plan. We believe such allocation information is essential to one group of primary users of plan financial statements – the participating cost-sharing employers – and would not be detrimental or misleading to other users. Using our recommendation for the allocation method described in the previous comment, the statement would present each employer’s covered payroll. Including the information as a statement or required note disclosure would subject it to audit and would provide reliable and verifiable information for participating employers to assess when reporting their share of pension elements. While we recognize that providing this statement or required disclosure would require additional efforts by the plans and their auditors, we believe it would go a long way in alleviating

requests of the plan by each cost-sharing employer (which in some cases number in the thousands) to verify its allocation. If the Board does nothing to address this issue and decides to let the marketplace determine a solution, the Board should be aware that we believe a substantial burden will be placed on cost-sharing plans. Each participating cost-sharing employer will have to individually work with the plan to understand the allocation and test the inputs. Further, each employer's auditor would have to gain an understanding of the plan's allocation process and controls and test underlying data at the cost-sharing plan level.

Plan net position greater than the total pension liability (paragraph 151): For overfunded plans where plan net position is greater than the total pension liability, the Proposed Statement does not provide any guidance on the classification of the net pension asset (or net debit) on the employer's balance sheet. The Basis for Conclusions (paragraph 151) states that this will be addressed in a separate project. We believe this is an important element of the employer's financial reporting model for pension plans. We encourage the Board to reach a conclusion on this issue as soon as possible to avoid inconsistent balance sheet presentation by different employers.

Glossary: The Proposed Statement defines defined contribution and defined benefit pensions consistently with ASC 715-30. Based on our experience with plans accounted for under ASC 715-30, a pension plan may exist that does not clearly meet either definition, perhaps because the plan has elements of both defined contribution and defined benefit plans. For example, some pensions plans allow a plan participant at age 65 to roll over a defined benefit pension into an investment account (known as a drop account) that has some characteristics of a defined contribution plan. We believe these types of plans exist for some state and local government employers.

In our view, it is important to clarify the accounting in these situations. In particular, we believe additional guidance is necessary to improve comparability between employers with similar arrangements. For example, without additional guidance, one employer may account for a hybrid plan as a defined benefit plan, with the net pension liability recorded on its balance sheet, while another employer with a similar hybrid plan may apply defined contribution plan accounting, with the liability on the balance sheet limited to the unpaid contributions at the reporting date.

The Board could develop a different accounting approach for plans with characteristics of both defined benefit and defined contribution plans. This approach, however, would likely require additional research and analysis that could delay the completion of a final standard. For this reason, we recommend the Board consider establishing a presumption, similar to ASC 715-30, that any plan that is not a defined contribution plan should be accounted for as a defined benefit plan.

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We would be pleased to discuss our comments with the Board members or the GASB staff at your convenience.

Very truly yours

