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ATTN: Director of Research and Technical Activities, Project No. 34-E

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**Written Comments in Response to the Exposure Draft
of the GASB on Proposed Statement for
Accounting and Financial Reporting for Pensions
Amending GASB Statements No. 25 and 27**

**Dated June 27, 2011
Project No. 34-E**

Introduction

We appreciate the opportunity to submit comments to GASB on the Exposure Drafts dated June 27, 2011. We respect the Board's commitment to promoting the objectives of financial reporting. Our goal in this response is to frame our comments in a manner which will assist the Board in its goal of promoting those objectives. This response addresses only the specific areas of our primary concerns.

One Milliman consultant has worked with the Conference of Consulting Actuaries subcommittee members on an extensive written response to the Exposure Drafts. This letter follows that document closely in most places while not going into the same level of detail. The co-signers of this document generally agree in substance with the majority view expressed in that document and this letter. While not all of us have had a chance to explore the issues in depth and, whereas it is not possible for all of us to be in agreement on all aspects of the Exposure Drafts, this letter reflects a general consensus of our views.

Please note that it is Milliman's policy that individuals are free to comment on professional matters. As with other large professional organizations, it is difficult to get agreement to issue a statement on any subject. Thus, given the nature of the Exposure Drafts, we are submitting this letter as individual consultants rather than as a statement of our firm.

Overview and General Areas of Agreement and Concern

We wish to reinforce the exposure draft's use of the expected long-term return on investments and the level-service cost method known as Entry Age Normal as we believe these reflect the long-term nature of the pension obligation and the career nature of the employment exchange.

Our concerns generally revolve around two needs:

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

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We are still concerned that the separation of accounting and funding in the exposure draft will have the following unfortunate consequences: 1) The accountability of governmental entities to consistently make contributions to finance their unfunded obligations will be reduced. 2) Various users of accounting and funding information will be confused by the existence of multiple measures.

Many of the new calculations required by the Exposure Drafts, including some of the more difficult to obtain results, would be needed solely for the employer's financial reporting and are otherwise not 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. Therefore, GASB should attempt wherever possible to have the details of Net Pension Liability (NPL) and pension expense calculations be as consistent as possible with established practice and the actuarial calculations already required by the plans.

In cases where complexity and cost are added in order to produce employer financial reporting information, it should be clear there is correspondingly significant improvement in the practical decision-usefulness of the information, in order to justify 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.

Consistency of NPL with Expense and Volatility of NPL

We appreciate the five-year smoothing used in the assets of the pension expense to define deferred inflows and outflows in paragraph 28 of the Statement No. 27 exposure draft. We will refer to this as the "ED smoothed assets." We believe the ED smoothed assets would also be a more consistent, reliable and decision useful measure for the NPL which will be shown on the employers' balance sheets than the Market Value of Assets (MVA) measure currently defined as the Plan Net Position. In addition, although all other deferred inflows and outflows from the expense will often be smaller in magnitude, we believe reflecting them directly in the NPL would also increase its year-to-year consistency, reliability and decision-usefulness and increase the consistency of the balance sheet with the pension expense. Therefore, we propose the following two alternatives, listed in order of our preference.

Alternative 1: We recommend the NPL be based on the ED smoothed assets and reflect all other deferred inflows and outflows of resources from the pension expense. An adjustment for all deferred inflows and outflows of resources would be shown on the financial statements just below the NPL resulting in an adjusted NPL based on MVA. This will increase the consistency, reliability and decision-usefulness of the NPL. It will also tie the balance sheet more tightly to the pension expense while still showing an adjusted NPL consistent with the NPL currently described in the Exposure Draft.

Alternative 2: Alternatively, if MVA is used to determine NPL we strongly encourage that all deferred inflows and outflows still be shown on the financial statements directly below the NPL. In this second alternative there would still be an adjusted NPL, but in this case it is the

adjusted NPL which would reflect the ED smoothed assets and all other deferred inflows and outflows.

Schedule of Net Pension Liability

We recommend the Schedule of Net Pension Liability be amended to show values calculated using both MVA and the ED smoothed assets.

Amortizations of Deferred Outflows and Inflows of Resources

We appreciate the GASB's desire to have all experience gains and losses and assumption changes reflected in the pension expense over the active service lives of the corresponding members. However, the approach described in the Exposure Draft where a period is used that provides a similar result to that obtained if such changes were recognized separately over the employees' expected remaining service lives does not reflect the pooled nature of a pension plan, and taken to the extreme could result in unintended consequences and unnecessary additional actuarial expenses. The approach described in the Exposure Draft can be inconsistent with plan experience, and also requires calculations that are not required or even developed for any other purpose. We believe this is a situation where established procedures currently in use would substantively accomplish the GASB's conceptual intent in a practical manner consistent with the long-term pooled operation of the pension plan.

We believe the experience of inactive members should not be treated differently than the experience of active members. All gains and losses and changes in assumptions whether applied to active or inactive members represent recalibrations of plan experience. Gains and losses represent actual experience different than assumed experience. Assumptions are periodically revised generally based on the same actual experience in order to reduce the incidence of future gains and losses. Both gains and losses and assumption changes recalibrate the calculated value of liabilities to represent the best estimate of future experience. This is equally true for both active and inactive assumptions. Inactive experience is not expected to converge to the actuarial assumptions faster than active experience. Both are best estimates. Inactive gains and losses are no more immediate than active gains and losses. Both have already occurred based on actual experience. Actual experience will never exactly match the best estimate assumptions and best practices require there will always be periodic adjustments to the actuarial assumptions. Recalibrations are necessary.

The question at hand is the period over which these recalibrations will be recognized. The GASB has followed the "overriding principle - that the cost of an employee's pension should be recognized during the periods that the employee provides service to the employer" (paragraph 223). We appreciate the connection between this overriding principle and spreading the aforementioned recalibrations over the separately corresponding service lives. Recognizing recalibrations over the remaining service lives of the current active membership is one financially reasonable method that is consistent with measures and procedures that are already available. However, separating out active and inactive member experience, while theoretically pleasing from one perspective, adds significant complexity to the underlying calculations. This complexity will decrease transparency and increase actuarial expenses without materially improving the interperiod equity of the disclosures.

One example of unintended consequences is the case of a plan with 10 retirement eligible employees at an age where there is a 20% probability of retirement. If, as expected, two of the 10 employees retire, there will typically be a loss for the two members who retire which is offset by a gain for the eight members who did not retire resulting in no aggregate gain or loss.

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However, if the gains and losses are recognized over the individual member's expected future working lifetimes, the loss for the two retirees, with no future working lifetime, will be recognized immediately whereas the gain from the eight members who did not retire will be recognized more slowly over their future working lifetimes. Therefore, an event with no aggregate gain or loss could initially result in recognition of a net loss if the precepts of the exposure draft are followed. This does not seem consistent with the goals of the Exposure Draft and is not consistent with the pooled nature of retirement plan experience.

Recommendation: We recommend that instead of recognizing gains, losses and assumption changes over an average expected remaining service life which approximates the result that would be obtained if such changes were recognized separately over the employees' expected remaining service lives, the changes for both active and inactive members should be recognized together over the pooled future service of all active members. To increase the comparability of reporting between public retirement systems, to increase transparency and to reduce increases in the actuarial expenses associated with reporting we recommend a single period be used, such as 10 years, that is generally representative of the average future working lifetime of active members. Note that based on analyses performed on various plans by our consultants 10 years is generally representative of an un-weighted average future working lifetime whereas seven years would be generally representative of a liability weighted average future working lifetime. Using either period for these deferrals will not result in a material decrease in the interperiod equity of the disclosures.

Disclosure Discount Rate Calculation

We support GASB's decision that the discount rate be based on the long-term expected rate of return on pension plan investments that are expected to be used to finance the payment of pensions. We ask for one clarification. We believe the projection of plan assets to depletion date is unnecessary for plans receiving contributions according to an actuarially determined funding policy designed to finance the normal cost and the unfunded actuarial accrued liability.

Recommendation: We recommend that GASB provide an exemption from the detailed testing in the final standards providing that the plan provides:

1. Background on the adopted funding policy and the actuarially determined contributions; and
2. Sufficient contribution history that supports the adherence to the funding policy.

Regarding multiple employer plans, we recommend it be made clear in the final disclosure statements that the discount rate must be determined at the plan level to avoid any issues or disagreements with the individual employers regarding assumptions, cash flows and appropriate municipal bond rates.

Multiple Employer Participating Employers with Different Fiscal Year Ends

The Timing and Frequency sections of the Exposure Draft require measurement at the end of the employer's reporting period. Whereas we recognize this represents an ideal, we do not believe it is practical. This could be a significant and unnecessary burden for agent and cost-sharing multiple employer plans. Due to the long-term nature of the commitment, we believe there is no need to perform additional asset or liability valuations, unless, of course, there exists one or more significant events that would merit such a re-valuation or roll-forward.

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The multiple employer plans we work with have employers with up to 12 different fiscal year-ends. Therefore, to follow this proposal to the letter, up to 12 asset valuations would need to be performed on assets of the total trust fund. Such frequent valuations would likely prove challenging insofar as they would require ongoing and timely valuation of illiquid assets held in hedge funds, private equity and real estate asset categories. It is likely that the practical difficulties associated with valuing such assets would delay reporting to employers, and each valuation would translate to significant time, effort, and administrative and audit-related costs for the fund, as well as, similar burdens of staff time and auditing cost elements on behalf of the individual employer. The alternative would be to use unaudited assets, but this seems unlikely to be embraced by the employers' auditors.

The various asset valuations and roll-forwards of liabilities also would create an inconsistency between total disclosure amounts published for the pension plan and the amounts disclosed in the employer-specific (proportioned) disclosure information.

Recommendation: Because of the long-term nature of a pension plan and the additional administrative costs and reporting complexities of the proposed requirements, we believe it would be sufficient for individual participating employers to use asset and liability valuation results calculated at the plan's year end provided:

1. The employer's year end is within a 12-month period of the most recent valuation of the trust assets; and
2. No subsequent significant events have occurred.

For plans that perform biennial valuations, we propose the requirement of a single one-year roll-forward of liabilities and re-valuation of assets at the "off-year" plan year end. These values would then be used by all participating employers with year-end dates falling within the "off-year" 12-month cycle.

Proportionate Shares for Cost Sharing Employers

We believe the Exposure Draft's direction to have each cost sharing employer's proportionate shares determined based on "projected long-term contribution effort" is as reasonable as any other method, but would be improved with further definition including simplification. Specifically, in most uncomplicated situations, where there is no reason to expect that the proportion of future contributions will be materially different from current contributions, the proportions determined based on the employers' proportionate share of current contributions would have no material difference from the proportion determined based on "projected long-term contribution effort." Therefore basing proportionate share on current contributions would significantly reduce the complexity and administrative burden of the calculation without reducing its accuracy and decision usefulness.

In addition we believe there is need for one or more safe harbors for plans with unconditional special funding situations, employers with a defined or limited time commitment, or employers who, for various reasons, have significantly uneven projected contribution patterns. We recommend a safe-harbor method that bases the proportions on the present value of each contributing entity's total projected contributions over the period in which the NPL is projected to be financed based on all future contributions. This calculation would be based upon the same actuarial assumptions used in the calculation of the NPL. If the NPL is not projected to be financed over any future period, then the present value of future contributions could be

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calculated over the next 20 years, or another period the GASB believes is more suitable. Adoption of either of these alternatives would make it clear that cost-sharing employers are not tasked with calculating the present value of future contributions extending into eternity.

Extending this discussion by one more logical step, once the proportionate share of a special group of employers with an irregular future contribution pattern is separated off based on the present value of their contributions, the proportionate share for employers within the group should be able to be separated out based on their current contributions as a percent of total contributions. For example, there are statewide cost sharing systems where future employees hired by university employers go into a defined contribution (DC) plan (sometimes called an "ORP" or Optional Retirement Plan) instead of the defined benefit (DB) plan. The university employers then make a set contribution as a percent of pay of those new employees in the DC plan for a set number of years to pay for the unfunded liabilities associated with the university employers' past hires who are in the DB plan. In this example there are two "groups" of employee payrolls on which employers are making percent-of-pay contributions: DC employees and DB employees.

We suggest a two-step process in this example: (1) Following the discussion in the second paragraph of this section the proportionate share of the two groups would first be determined based on the present value of their future contributions over the period in which the NPL is projected to be financed based on all future contributions. The result would be two proportions: DC and DB. (2) Next, the two pools could be separated by current contributions as described in the first paragraph. This method has the advantage that only one complicated separation is required. For example, if the first step allocated 90% to the DB employers then that 90% could be allocated by current contributions. If there were 700 employers this would avoid the need to separately calculate the present value of all 700 employers' future contributions. It would only have to be done once in the aggregate.

Recommendation:

1. In uncomplicated situations allow a proportionate share to be determined by prior year contributions or anticipated contributions in the following year.
2. When future contributions for some groups are projected to follow irregular patterns, allow a safe harbor that proportionate share will be determined based on the present value of future contributions as described above.

Permitted Use of Ongoing Allocations/Attribution Methods

If a cost-sharing plan has in place a reasonable and reliable attribution method for purposes of allocating liabilities, assets and/or contribution requirements, then the plan should be allowed to continue the practice as long as a thorough description of the method of allocation is included in the notes to disclosure.

Treatment of Investment Expense

Regarding the development of pension expense, depending on whether or not the expected rate of return is declared as "net of administrative expenses", it may be inappropriate to have a separate line item for "Administrative Expenses". We recommend adding language to the proposed requirements recognizing that if the long-term expected rate of return is net of administrative expense, in essence, the service cost item would include the assumed element of expenses and no additional line item within Pension Expense would be necessary.

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Expected Investment Rate of Return

We believe there is an implicit misunderstanding pertaining to the use of expected geometric mean rates of return to develop the investment return assumption, as shown in Illustration 3, page 50 of the GASB ED No. 25. Under the building block approach, as it turns out, one cannot weight expected geometric mean returns by asset class to derive an expected geometric mean return for the portfolio. This could be corrected by saying that the example is using best estimates of arithmetic returns and does not cover all legitimate methods.

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