

Government Finance Officers Association

Testimony before the

GOVERNMENTAL ACCOUNTING STANDARDS BOARD

Concerning its exposure drafts on

*ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS:
AN AMENDMENT OF GASB STATEMENT NO. 27*

and

*FINANCIAL REPORTING FOR PENSION PLANS:
AN AMENDMENT OF GASB STATEMENT NO. 25*

**East Elmhurst, New York
October 4, 2011**

We are here today on behalf of the Government Finance Officers Association (GFOA) to offer testimony on the Governmental Accounting Standards Board's (GASB) recent exposure drafts on the appropriate accounting and financial reporting for pension benefits, both by employers and by pension plans. This testimony was prepared by the GFOA's standing Committee on Accounting, Auditing, and Financial Reporting (CAAFR) and the GFOA's standing Committee on Retirement and Benefits Administration (CORBA), which advise the GFOA's Executive Board on all matters related to accounting and financial reporting for pensions and benefits.

GFOA'S VIEW OF GASB'S OVERALL DIRECTION

As you know, the GFOA strongly supported the position that the board took in GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, in favor of a funding-focused approach to accounting and financial reporting for the cost of pension benefits. While the GFOA agrees that there is room for improvement, especially in light of more than ten years of experience, we remain convinced that the basic approach of GASB Statement No. 27 remains fundamentally sound and is uniquely well suited to the practical needs of decision makers.

The critical issue regarding pensions for decisions makers in the public sector is whether the cost of benefits is being funded in a systematic and rational manner over the active service life of benefitting employees. GASB Statement No. 27 made a historic contribution in this regard by 1) setting parameters to ensure the reasonable application of actuarial cost allocation methods, 2) clearly displaying whether employers are, in fact, meeting the goal of systematic and rational funding each period, and 3) highlighting the cumulative financial impact of underfunded contributions (*net pension obligation*). At the

same time, point-in-time information on overall funding progress is provided in both the notes to the financial statements and as required supplementary information (RSI).

In the GFOA's view, the approach put forward in the ED would mark a major step *backward* from the progress brought about by GASB Statement No. 27 by 1) replacing the critical information on funding just described with information *already available* in the notes to the financial statements (i.e., a net information *loss*), and 2) compromising the usefulness of the annual required contribution (ARC) for other purposes by eliminating the standardization that has been the indirect result of the application of the actuarial parameters set by GASB Statement No. 27.

Furthermore, as we noted in our testimony before the board concerning the preliminary views document that preceded these EDs, we remain firmly convinced that the unfunded actuarial accrued liability is simply too volatile to display as a liability on the face of the financial statements.

We believe that GASB Statement No. 27 can and should be improved, especially in regard to the amortization of various factors associated with the measurement of an employer's obligation to provide benefits (e.g., amortization of retroactive benefit enhancements). We do *not* believe there is cause to jettison the basic approach of GASB Statement No. 27 in favor of an alternative approach that promises little in the way of information of practical use to actual public-sector decision makers.

GFOA'S OVERALL POSITION ON THE EDS

The GFOA *supports* two aspects of the guidance proposed in the EDs:

- The GFOA applauds the board's proposal that employers continue to use the long-term rate of return on plan investments to discount their total obligation for pension benefits; and
- The GFOA also agrees that the effect of changes in an employer's total liability for pension benefits should be amortized during the remaining active service life of affected employees (i.e., immediate recognition in the case of inactive employees, including retirees).

Conversely, the GFOA *opposes* two elements of the guidance proposed in the EDs

- The GFOA adamantly opposes the board's proposal to abandon the use of the employer's ARC as the basis for measuring pension cost;
- The GFOA rejects the idea that individual employers in a cost-sharing plan should report a proportionate share of the total net liability and expense of all participating employers.

DETAILED COMMENTS

Measurement of an employer's total pension liability

The board has proposed that projected benefit payments include the effects of cost-of-living adjustments (COLAs) and other retroactive benefit changes that are either *automatic* or *substantively automatic*, 2) projected future salary increases, and 3) projected future service credits.

The GFOA supports this proposal without reservation.

At the same time, the board has refrained from offering specific criteria for assessing whether a COLA should be considered *substantively automatic*. Instead, the board has offered examples of the type of considerations that could be relevant in making such a determination.

The GFOA applauds the board for taking this approach, which is consistent with the GFOA's view that accounting and financial reporting standards should be principles-based to the greatest extent possible.

Discount rate

The board has proposed that the employer's total pension liability be discounted using a single rate that produces a present value of total projected benefit payments equivalent to that obtained by discounting projected benefit payments using (1) the long-term expected rate of return on plan investments to the extent that current and expected future plan net position available for pension benefits are projected to be sufficient to make benefit payments and (2) a high-quality municipal bond index rate for those payments that are projected to be made beyond the point at which plan net position available for pension benefits are projected to be fully depleted.

The GFOA strongly supports the GASB's principled decision to retain the long-term expected rate of return on plan investments as the discount rate, especially in the face of criticism from those advocating the use of a risk-free rate of return. The use of a risk-free rate of return, in our view, would seriously overstate pension expense and inevitably lead to inter-period inequity. We also agree with the board that a modification of this basic approach is appropriate for payments projected beyond the point at which plan net position are expected to be fully depleted. In this latter case, however, we believe the specific rate the board has proposed is too conservative and advocate instead the use of a high-quality taxable municipal bond index rate.

Choice of actuarial method

In our view, the single most important fact concerning pension benefits for most users of state and local government financial statements is whether the employer is funding the cost of those benefits in a systematic and rational manner. Mandating the use of an

actuarial method for accounting and financial reporting purposes that may differ from the method selected for funding purposes essentially frustrates this purpose and seriously compromises the utility of the information for most decision-making purposes.

The GFOA strongly opposes this proposed change.

The effect of changes in benefit levels

The board has proposed that the effect of a change of plan terms on the total pension liability be recognized as expense in the period of the change.

The GFOA believes that the effect of a change in benefit levels should be recognized, at latest, by the end of a benefitting employee's active service, if not immediately.

The effect of differences between projected and actual earnings on investments

The board has proposed that differences between actual and projected earnings on plan investments be recognized as deferred inflows/outflows of resources, and that the deferred amount be amortized over a five-year period, beginning in the period in which the difference occurred.

The GFOA supports the basic approach being proposed, but recommends the use of a longer amortization period to avoid the volatility inherent in using a point-in-time measure of plan net position.

The effect of differences between expected and actual experience with regard to economic or demographic factors

The board has proposed that the effect of differences between expected and actual experience with regard to economic or demographic factors be recognized over the remaining active service life of employees, meaning that any portion of the difference associated with *inactive* employees (including retirees) would need to be recognized immediately.

The GFOA supports this recommendation as being consistent with the notion that the total cost of pension benefits ought to be recognized over the active service life of benefitting employees.

The effect of a change in assumptions about economic or demographic factors.

The board has proposed that the effect of a change in assumptions about economic or demographic factors be recognized over the remaining active service life of employees, meaning, that any portion of the difference related to *inactive* employees (including retirees) would need to be recognized immediately.

The GFOA supports this recommendation as being consistent, once again, with the notion that the total cost of pension benefits ought to be recognized over the active service life of benefitting employees.

Participants in cost-sharing plans

The board has proposed that individual employers in cost-sharing plans each recognize their proportionate share of 1) the collective net pension liability of all participating employers, 2) the collective pension expense of all participating employers, and 3) the collective deferred pension outflows/inflows of resources of all employers.

The GFOA strongly disagrees. Unless a participating government is the predominant participant in a cost-sharing plan, the plan functions, for all practical purposes, in our view, as insurance from the vantage point of individual participating employers.

Actuarial updates

The board has proposed that actuarial measurements be updated to the reporting date if the actuarial valuation occurs as of some other date.

The GFOA supports this requirement.

As a final note, the GFOA recently was one of eight public interest groups that sent a letter to the board requesting that it extend the close of the period set for field testing and comment to no earlier than November 30, 2011. We urge the board to look favorably upon this request to ensure the maximum benefit from field testing.

The GFOA appreciates the opportunity to testify at this hearing.