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AMERICAN ACADEMY *of* ACTUARIES

April 2, 2012

Mr. David Bean  
Director of Research and Technical Activities, Project No. 13-3  
Governmental Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

RE: Preliminary Views on Economic Condition Reporting: Financial Projections

Dear Mr. Bean:

On behalf of the Public Plans Subcommittee and Pension Accounting Committee of the American Academy of Actuaries,<sup>1</sup> we appreciate the opportunity to provide comments to the Governmental Accounting Standards Board (GASB) on its *Preliminary Views on Economic Condition Reporting: Financial Projections*.

We specifically are writing to discuss the financial projections for pension and postretirement obligations from an actuarial perspective. We would like to respond in particular to some of the questions posed for respondents in the *Preliminary Views* with respect to pension and postretirement obligations. While our responses only directly apply to pension and postretirement obligations, similar principles may apply to the projections of other items as well.

We applaud the Board's intentions in seeking to expand the availability of information that is relevant and useful for financial statement users. While documenting (and auditing) what has happened in the past is clearly an important function of financial reporting, it is only part of the story. The Board also should consider what might happen in the future and whether the entity has a credible and rational plan for dealing with it. These items are more judgmental in nature and might be more difficult to "audit" in the traditional sense of the word. We also applaud the Board's recognition of the need to balance the cost of preparing the additional information with the benefit of including it in the financial statements.

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<sup>1</sup> 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.

1. **The Board’s preliminary view is that there are five components of information that are necessary to assist users in assessing a governmental entity’s fiscal sustainability (Chapter 3, paragraph 2):**
  - **Component 1—Projections of the total cash inflows and major individual cash inflows, in dollars and as a percentage of total cash inflows, with explanations of the known causes of fluctuations in cash inflows (Chapter 3, paragraphs 4–9)**
  - **Component 2—Projections of the total cash outflows and major individual cash outflows, in dollars and as a percentage of total cash outflows, with explanations of the known causes of fluctuations in cash outflows (Chapter 3, paragraphs 10–14)**
  - **Component 3—Projections of the total financial obligations and major individual financial obligations, including bonds, pensions, other postemployment benefits, and long-term contracts, with explanations of the known causes of fluctuations in financial obligations (Chapter 3, paragraphs 15–20)**
  - **Component 4—Projections of annual debt service payments (principal and interest) (Chapter 3, paragraphs 21–23)**
  - **Component 5—Narrative discussion of the major intergovernmental service interdependencies that exist and the nature of those service interdependencies (Chapter 3, paragraphs 24–26).**

**Do you agree with this view? Why or why not?**

For pension or postretirement obligations, projections of the assets, liabilities, contributions, benefit payments, and investment returns net of expenses are all components that are necessary to assist users in assessing fiscal sustainability. A single-scenario projection illustrates an entity’s planned future trend in cash flows or obligations and is useful in that limited regard. Such a projection, however, might also be misleading, generating a false sense of security that the projected result is the likely outcome. (In reality, of course, projection estimates based on assumptions are almost never exactly right.)

We are concerned that a narrative explanation of the known causes of fluctuations may be insufficient to convey the likely volatility in the single-scenario projections. The cautionary notice described in Chapter 5, paragraph 28 warns the user of potential variance from the projection and the narrative explanations of known causes in fluctuations provide some additional information. The magnitude of the likely variations and the potential impact of these variations on fiscal sustainability, however, depends on a number of factors, including the investment policy of the plan and the size of the plan compared to the entity.

For example, assume there is a pension plan with \$1,000 in assets invested in a portfolio with an expected geometric return of 7 percent and an annual standard deviation of 10

percent.<sup>2</sup> Further assume that contributions exactly offset benefit payments. The table below shows the percentiles of the distribution of the projected growth in pension assets over five years.

<b>Distribution of Projected Assets</b>					
<b>Expected Geometric Return = 7%, Standard Deviation = 10%</b>					
<b>Percentile</b>	<b>Year 1</b>	<b>Year2</b>	<b>Year 3</b>	<b>Year 4</b>	<b>Year 5</b>
95 <sup>th</sup>	\$1,247	\$1,421	\$1,596	\$1,779	\$1,974
75 <sup>th</sup>	\$1,139	\$1,251	\$1,365	\$1,486	\$1,613
50 <sup>th</sup>	\$1,070	\$1,145	\$1,225	\$1,311	\$1,402
25 <sup>th</sup>	\$1,005	\$1,048	\$1,099	\$1,156	\$1,219
5 <sup>th</sup>	\$ 918	\$ 922	\$ 940	\$ 966	\$ 997

Based solely on the expected variability of the assets of the pension plan (and not the liabilities), the projected net pension liability after one year would be expected to fall within a range that is \$134 (\$1,139 - \$1,005) wide for half of the outcomes and \$329 (\$1,247 - \$918) wide for 90 percent of the outcomes. After five years, the range would be \$394 wide for half of the outcomes and \$977 wide for 90 percent of the outcomes. The significance of this depends on the size of the organization. For example, if annual revenues are \$200, the potential range of \$977 in the fifth year represents nearly five times annual revenue, but if annual revenues are \$1,000, the potential range of \$977 in the fifth year is less than one times annual revenue.

While multiple scenario projections may be the best way to illustrate the interaction of these factors and their potential impact, other indicators could be used in the narrative description to convey the magnitude of variation that may be likely in the projections. These indicators might include an estimate of the standard deviation of investment returns and measures of the assets and liabilities of the plan compared to the total projected cash inflows for the sponsoring employer(s) or compared to the covered payroll of the plan.

Well-communicated projections would educate the user about the potential or likely variability of future outcomes.

- 2. The Board’s preliminary view is that financial projections should be (a) based on current policy, (b) informed by historical information, and (c) adjusted for known events and conditions that affect the projection periods. Current policy includes policy changes that have been formally adopted by the end of the reporting period but that will not be effective until future periods (Chapter 4, paragraphs 2–7). Do you agree with this view? Why or why not?**

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<sup>2</sup> These are hypothetical expected return and portfolio standard deviation assumptions for illustration purposes and are not an endorsement of any particular set of assumptions. Expected return and standard deviation assumptions applied to any particular situation will depend on a variety of factors—including portfolio composition, investment policy and market conditions—and could be significantly different.

We agree that beginning each projection with “current policy, informed by historical information and adjusted known events and conditions,” is appropriate and rational, as future plans should always be updated as current conditions change.

- 3. The Board’s preliminary view is that inflows and outflows should be projected on a cash basis of accounting, and financial obligations should be projected on an accrual basis of accounting (Chapter 4, paragraphs 8–12). Do you agree with this view? Why or why not?**

For pension and other postretirement (OPEB) obligations, we believe the projection of the financial obligations should include the total pension/OPEB liability, the plan net position, and the net pension/OPEB liability. Projections of just the net pension/OPEB liability may obscure the potential volatility in the measure. In addition, it is not clear what value would be obtained by projecting the net pension or OPEB obligation in the current standards.

- 4. The Board’s preliminary view is that the identification and development of assumptions for making financial projections should be guided by a principles-based approach. Such an approach would set forth principles that require assumptions to be based on relevant historical information, as well as events and conditions that have occurred and affect the projection periods. Furthermore, these assumptions should be (a) consistent with each other (where appropriate) and with the information used as the basis for the assumptions and (b) comprehensive by considering significant trends, events, and conditions (Chapter 4, paragraphs 13–16). Do you agree with this view? Why or why not?**

We agree that projection assumptions should be principles-based and “consistent with each other (where appropriate) and with the information used as the basis for the assumptions and comprehensive by considering significant trends, events, and conditions.”

- 5. The Board’s preliminary view is that annual financial projections should be made for a minimum of five individual years beyond the reporting period for the purpose of external reporting (Chapter 4, paragraphs 19–23). Do you agree with this view? Why or why not?**

For long-term obligations such as pension and OPEB obligations, five years may be too short of a projection to understand the anticipated trends, particularly when assets often are smoothed over five years and gains and losses may be amortized over a period of 15 to 30 years. For example, following the market decline of 2008, five-year projections might have shown both increasing unfunded liabilities throughout the projection period and increasing contribution rates as plans gradually adjusted their contribution rates to reflect the new level of funding required. With a five-year projection, users might have incorrectly concluded that the plan was not fiscally sustainable when longer-term projections might have shown that current policies eventually would result in a stabilization of contribution rates and a restoration of balance in the plan. On the other

hand, it is also possible that a short-term projection that shows balance and sustainability could be masking a longer-term policy insufficiency or exposure to risk.

We look forward to continuing to work with the GASB on these important issues, and are available to discuss these issues in more detail if desired. Please contact Jessica M. Thomas, the Academy's senior pension policy analyst ([thomas@actuary.org](mailto:thomas@actuary.org); 202-785-7868) for additional information.

Sincerely,

Stephen A. Alpert, FSA, FCA, MAAA  
Chair, Pension Accounting Committee

William R. Hallmark, ASA, FCA, MAAA  
Chair, Public Plans Subcommittee