



AMERICAN ACADEMY *of* ACTUARIES

October 14, 2011

Director of Research and Technical Activities
Project No. E-34
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116
director@GASB.org

Re: Exposure Draft on *Pension Accounting and Financial Reporting by Employers*

Dear Mr. Bean:

On behalf of the American Academy of Actuaries'¹ Public Plans Subcommittee and Pension Finance Task Force² I appreciate the opportunity to provide their responses to the 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*. Our Academy groups have observed with keen interest the evolution of the project on pension accounting and financial reporting of the Governmental Accounting Standards Board (GASB) and have enjoyed participating in the deliberative process over the past two years through public comment and hearings. It is clear that a considerable amount of thought and research on the part of GASB board members and staff went into developing the two exposure drafts.

The Academy's mission is to provide independent and objective information, analysis, and education for the formation of sound public policy where actuarial science provides a unique understanding. In some cases, divergent stakeholder perspectives and needs can result in a number of possible policy solutions for policymakers to consider and balance simultaneously. For this reason, the response from the Academy's Pension Practice Council to the drafts includes two separate responses to the questions presented, one response prepared by the Pension Finance Task Force and another prepared by the Public Plans Subcommittee. We hope the GASB will find both responses informative and useful. The Academy would be happy to provide further details or any additional assistance as this research project continues.

Please contact Jessica M. Thomas, the Academy's senior pension policy analyst (202-785-7868, thomas@actuary.org) if you have any questions, would like to discuss these responses further, or

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.

² The Pension Finance Task Force is jointly sponsored by the American Academy of Actuaries and the Society of Actuaries.

would like to see the Academy's response to the 2009 Invitation to Comment³ and 2010 Preliminary Views⁴ document.

Sincerely,



Ethan E. Kra, FSA, MAAA, EA
Vice President, Pension Practice Council
American Academy of Actuaries

³ http://www.actuary.org/pdf/pension/gasb_aug09.pdf

⁴ http://www.actuary.org/pdf/pension/Academy%20GASB%20PV%20Response%20FINAL%209_17_10.pdf

Response from the Pension Finance Task Force

The Joint American Academy of Actuaries/Society of Actuaries Pension Finance Task Force appreciates the opportunity to submit comments on the exposure drafts of the amendments to GASB Statement Nos. 25 and 27. We support defined benefit pension plans in the public sector and the important role that robust financial reporting of those plans can play in their acceptance by the tax-paying public.

We were pleased to see several proposed improvements, both to the current rules and to the preliminary views. These improvements include the board's decisions: (1) to recognize a net pension liability; (2) to stipulate a single actuarial method to calculate liabilities and annual costs; (3) to reduce significantly deferrals of current costs; and (4) to expand the required disclosures.

We disagree, however, with other aspects of the drafts. We particularly disagree with the rules for determining discount rates. We also disagree with the choice of entry age normal as the mandated method to determine liabilities and periodic costs. These are matters that we discussed in our response to the preliminary views and we have included much of the same reasoning in this response. The drafts would have the net pension liability reported using the entry age normal cost method and using a discount rate based on the expected rate of return on invested assets. We describe in some detail below why we believe neither of these approaches is appropriate to financial statements. In addition by *requiring* reporting on this basis, plan sponsors who report or intend to report on a more economically representative basis would be discouraged or prohibited from doing so. This is a step backwards, in our opinion. The difference (an understatement, typically) is particularly important for mature plans, in which the bulk of the liability is for retired and terminated plan members, and for which the overstatements inherent in salary scales and entry age normal methods do not counteract the understatement inherent in a discount rate that reflects anticipated returns on equities.

We believe that all interested parties, especially taxpayers and bondholders, need to see the value of the pension obligation reported in a manner consistent with the fundamental principles of economics, and the presentation of other debt of the government.⁵ Mr. Donald L. Kohn, then vice chairman of the Federal Reserve System, made the following pertinent remarks in the spring of 2008:

The chief reason [that current measures of pension liabilities might be less than fully revealing] is that public pension benefits are essentially bullet-proof promises to pay... For all intents and purposes, accrued benefits have turned out to be riskless obligations. While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: The only appropriate way to calculate a present value of a very-low-risk liability is to use a very-low-risk discount rate.

⁵ Tradable government debt is reported at the value received in the markets when first sold and is then systematically amortized until the debt is extinguished. Pension debt is not easily valued in this way, but approximate consistency can be achieved.

However, most public pension funds calculate the present value of their liabilities using the projected rate of return on the portfolio of assets as the discount rate. This practice makes little sense from an economic perspective. If they shift their portfolio into even riskier assets, does the value of the liability backed by the taxpayer go down? Financial economists would say no, but the conventional approach says yes. Unfortunately, the measure of liabilities that results from this process has a real consequence: it pushes the burden of financing today's pension benefits onto future taxpayers, who will be called upon to fund the true cost of existing pension promises.⁶

Our view is that the pension obligation is a liability that should be discounted at close to a default-free rate for presentation in the balance sheet. Certain consequences flow from this point of view:

- First, the annual cost becomes the balancing item between last year's pension liability and this year's pension liability and is likely to show a great deal of volatility. It is our understanding that reducing volatility is not an objective of financial reporting methods—although it may be an objective of cash contribution methods. This is to the detriment of faithfully reporting the economics of the plan. To make sure this volatile annual cost is presented in a way that meets the GASB's objectives, it will be important to separate the compensation cost of the plan (i.e., the portion of the annual cost attributable to benefits earned during the reporting period) from the costs (i.e., financing and investment costs, gains and losses, etc) attributable to risks taken and estimates made.
- Second, other information not reported in the balance sheet or the income statement is important enough to warrant disclosure in the footnotes. In particular, footnote disclosures should include a description of the plan's funding policy, the current and expected level of future cash flows, and the investment policy of the trust fund including its allocation among different asset classes.

Our responses to the questions (in the supplement to the exposure drafts) thus reflect this broader view of financial reporting of pension obligations.

1/2. Do you agree or disagree with the GASB's proposal that governments recognize the net pension liability in their financial statements? Why do you agree or disagree?

We agree with the drafts that the unfunded portion of a sole or agent employer's pension obligation to its employees meets the definition of a liability and should be recognized in the entity's financial statements. The employer has promised a future financial benefit to its employees, the employees have accepted that promise in lieu of other forms of compensation, and the employees can press their rights in the courts with a reasonable prospect of success. An obligation therefore exists and should be reported.

The assets accumulated in the trust fund will be used to satisfy the employer's pension obligation. The balance sheet certainly should show at least the net position. We believe users would be even better served if assets and liabilities were reported separately. It is more useful to

⁶ Speech delivered on May 20, 2008 at the National Conference on Public Employee Retirement Systems Annual Conference in New Orleans, LA. Available at <http://www.federalreserve.gov/newsevents/speech/kohn20080520a.htm>

report that assets and liabilities are each, for example, \$10 billion than to report merely that the plan is fully funded.

Although we agree that the net pension liability is measurable and should be recognized in the employer's financial statements, measurement can be difficult. The obligation involves uncertain future cash flows, it is not traded in markets and the tax status of the relevant cash flows is very different from the cash flows of the employer's tradable debt. Despite these factors, techniques exist to measure the obligation with sufficient reliability for the financial statements. More important still, the obligation is so large, in many cases, that failure to report it may seriously mislead users of the financial statements as to the employer's financial position.

3/4. Do you agree or disagree with the GASB's proposals for how the total pension liability should be measured? Why do you agree or disagree?

It is important to note that our observations in response to these questions relate only to financial reporting, and not, for example, to contribution budgeting.

On the treatment of future salary increases, future service credits and cost-of-living adjustments (COLAs),

We believe that *future salary increases* generally should **not** be included in the value of the obligation until the salary increase is granted. Future salary increases are not otherwise part of an employer's obligation as is, for example, an obligation to make contributions to a defined contribution plan that is salary dependent. The future salary increase itself also is not an obligation of the employer. Appropriate decisions about the workforce and compensation cannot be made when real current costs of employment are not being recognized. We think, therefore, that the obligation should not reflect an estimate of future salary increases.

The value of benefits that will be earned by the employee based on *future service credits* is not ordinarily part of the current obligation and its value accordingly should not be included in the reported obligation. Use of the entry age normal (EAN) method proposed in the drafts generally would attribute some of the cost of future service credits to past years in an attempt to achieve level costs over time. But in determining eligibility for benefits (as opposed to benefit amounts), e.g. for subsidized early retirement benefits, even when those future benefits are limited to benefits accrued to date, the probability of future service credits should be considered. The benefits have been earned and it is reasonable to recognize the obligation for them, based on an estimate of whether a contingency (which is largely in control of the employee - in contrast to salary increases) will be eliminated in the future.

A pattern of *ad hoc COLAs* is a necessary but insufficient condition for inclusion. In general, ad hoc COLAs are discretionary because the employer retains the right to determine the timing and amount. Inclusion before COLAs are awarded does not properly respect the right retained by the employer. The retained right, however, can vary in strength. It may be appropriate, therefore, to anticipate COLAs in whole or in part, as justified by facts and circumstances. The observation (in the 2009 Invitation to Comment) that the inclusion of projected COLAs may lead to expectations that they will be granted because they "already have been accounted for ..." is an important consideration with respect to decision-usefulness.

On the use of the entry age normal actuarial cost method,

We agree with the board that a single methodology for attributing costs to periods is appropriate and promotes comparability. We do not agree with the drafts that the value assigned to the pension benefits exchanged for services each year over an employee's career should bear a consistent relationship to the employee's base salary level. We also do not agree with the drafts in using an EAN approach to measure the obligation at a point in time.

For active employees and assuming that the actuarial assumptions are consistent with those that would be used to generate a fair value of the obligation, EAN generates a liability in excess of the value of the benefits accrued to the reporting date. With respect to retired and terminated vested lives, EAN generates the same value of expected future benefits as under all other proposed methods. We believe a preferable approach for active employees would be to recognize, in the balance sheet the value of the benefits accrued to date. This would determine a balance sheet liability that is consistent conceptually with the value of other debt in the balance sheet. The cost of benefits accruing in the period generally would be the balancing item.

EAN is a mechanism designed to create smooth and stable cost patterns, not a method to represent the current obligation of the plan sponsor. Traditional defined benefit plans sponsored by governmental entities are usually "final-pay" plans, a design that generates increasing accrual patterns as employees age (i.e., as an employee accumulates more service, any increase in pay is applied not only to the current year of service, but also is applied to all past years of service). EAN levels out the costs, usually as a percentage of payroll, over the period of an individual's employment. We believe reflecting the actual pattern by which benefits are earned under the terms of the plan is consistent with, and better reflective of, a sponsor's obligation. This would be accomplished by use of the traditional unit credit (TUC) cost method.

Because the EAN generates a liability in excess of the value of benefits accrued to date, some believe that the EAN is a "conservative" actuarial method. The EAN, however, understates the annual cost for older employees since more of the value of the benefit is attributed to prior years instead of the current year. The EAN also understates the pension impact attributable to salary increases granted to older employees. Such understatements may be a barrier to good decision-making.

On the determination of a discount rate,

We disagree with the drafts on setting the discount rate because we believe that a balance sheet liability calculated under them would work against the GASB's objectives of accountability, decision-usefulness and assessment of interperiod equity. It would do so by requiring a metric that fails to represent faithfully the economics of the plan and sponsor. It would thereby work against effective governance and plan management, potentially leading to poor compensation decisions.

The two-tiered discount rate structure in the drafts would result in a discount rate close to the expected return on assets (EROA) for most large, well-funded pension plans, and to a municipal

bond index rate for only the most unfunded plans. We will confine our remarks to the use of the EROA as a discount rate.⁷

Most large pension funds have substantial portions, often more than 50 percent, of their trust funds invested in equities. Expected returns on equities are usually higher than expected returns on bonds from the same issuer precisely because the returns on the underlying securities are more uncertain (or riskier) and market participants demand greater expected returns to compensate them for taking additional risk. As a result, the EROA rises as the actual or anticipated percentage of equities in the trust fund rises. The Preliminary Views document justified using the EROA as the discount rate as follows (Chapter 4, Paragraph 16):

To the extent that plan net assets available for pension benefits have been accumulated to date in the pension plan and are reasonably expected to grow during the time when benefit payments are being made from those assets, the Board believes that the present value of the employer's projected sacrifice of resources is effectively modified (reduced) by the expected return on investments.

We disagree with this logic primarily because it assumes that either (1) the risk of equities underperforming the expected return is minimal, or (2) there is no implicit cost to the risk of equities underperforming the expected return. In reality, the EROA is an expected value, not a certainty (or even as probable as the expected return from a matched portfolio of bonds) and there is a cost to assuming the risk of underperformance. Thus a discount rate based on the EROA of the actual portfolio typically understates the liability and passes the cost of bearing risk to future generations.

The discount rate should be based on the characteristics of the liabilities, rather than on those of the assets. Pension liabilities are most similar to fixed income investments because of the relatively predictable nature of the future benefit payment streams. A discount rate based on yields on fixed income investments a quality and term structure that is similar to the liabilities most appropriately will represent the economic value of the obligation.

Although the actual assets may be invested in something other than a matched portfolio, and asset gains and losses thereby occur, this deviation from expectation is a result of assuming risk. Also, the existence and materiality of this deviation is in contrast to the drafts' criterion for a discount rate that the assets be "reasonably expected to grow" to meet the liability cash flows. Furthermore, it does not have a significant impact on the value of the liabilities.

We present below several common situations in which using an EROA as a discount rate would work against effective governance, plan management and common sense.

⁷ There would be very few pension plans where a mixed rate structure would apply. In those cases, there is likely to be a good deal of confusion about how the standard is to apply. Two questions immediately come to mind. One, how to determine the discount rate if a future benefit is likely to be funded? Two, how is a user to understand that a mere commitment to more rapid funding unaccompanied by an immediate increase in assets results in a reduction in liability?

Example 1: Assessing the Level of Government Debt

Accurate assessment of the level of government debt is an important piece of information in assessing inter-period equity and accountability. It also is useful for any decision regarding the level of government debt. Pension obligation is a form of debt.

In our view, a discount rate based on the EROA is a poor choice for determining a balance sheet obligation. This can be seen clearly by constructing a hypothetical bond issue with a sinking fund invested in equities expected to yield 10 percent even though the bond itself is sold to yield 5 percent. If the rules proposed for pension accounting were applicable to this bond issue, the employer immediately would recognize a profit by booking the cash received as an asset but booking a liability of much less than the asset. From our perspective, the potential for this kind of "accounting arbitrage" is not desirable.

The pension obligation differs from the employer's tradable debt (publicly traded bonds) in several significant respects—it's seniority in bankruptcy is different; benefit payments are subject to income tax while debt service usually is not; it includes some demographic risks; and of course, it is not tradable. These considerations generally suggest modifying the employer's borrowing rate towards a default-free rate of return. Better yet, would be a yield curve of rates to reflect the fact that cash flows that differ in timing should be discounted at different annually compounded rates. In today's economic environment, we would expect to see effective rates under this approach of something like 3.5 percent to 5 percent, compared with a typical rate of return on plan asset expectations of around 7 percent to 8 percent.

Using a discount rate so much higher than the rate used for other government debt—both on the accounting statements and in the market for tradable debt—creates inconsistencies and underpricing of the pension obligation. This prevents an assessment of inter-period equity because it undervalues the debt incurred in specific periods. It presents challenges to accountability and decision-usefulness by obscuring the actual cost of decisions.

Example 2: Assessing Compensation Costs

Plan sponsors must know the annual cost of benefit accruals if they wish to assess their total compensation costs and the costs of individual elements of compensation. In collective bargaining situations, for example, negotiations often involve trading wages for benefits as well as negotiating the value of total compensation. In other situations, labor costs can affect decisions on employment and salary increase levels as well as project costs. It is extremely important, therefore, that the accounting costs be appropriate for these purposes.

Use of the EROA is not appropriate for this purpose for much the same reasons that it is not appropriate for determining the overall indebtedness of the employer with respect to the pension plan. The cost to the employer of promising to make a future payment to an employee depends on the specific conditions of the promise (e.g., constitutional protections, taxability to the beneficiary, existence of an investment trust). It is not dependent on how the employer hopes to invest the trust assets. If the employer were to try to settle the pension obligation owed to one or more employees (not that this is done often, but it is a way to understand the cost), no insurer or

other financially reliable third party would accept a dollar amount based on discounting an almost-certain debt at a discount rate that reflects what the insurer might earn if it invested the proceeds in risky assets. By not properly measuring the cost of compensation in a given period, the draft discount rate does not properly measure the cost of services in each period. As a result, it does not facilitate an assessment of interperiod equity.

To be more decision-useful and to allow more faithful assessment of interperiod equity, the discount rate should not reflect expected returns on risky assets as if they were guaranteed, but should reflect the nature of the promises themselves which are well represented by traded fixed-income instruments.

Example 3: Asset Allocation Studies

Many plans use asset-liability modeling (ALM) studies as the primary quantitative analysis for determining their asset allocation. ALM studies typically involve looking at key plan metrics under various asset allocations, then selecting the asset allocation that is considered to best balance risk and return. For asset allocations that reduce both expected return and risk, using the EROA as the discount rate causes an immediate increase in the liability and decrease in the funded status. This result creates a structural bias against an asset allocation that reduces expected return, even as it reduces risk and volatility. Using the EROA to discount the pension obligation, as a result, tilts the scales against a sponsor de-risking because of the negative impact on reported funded status.

In fact, as we have stressed elsewhere, a change in asset allocation should have no immediate effect on funded status (i.e., the value of assets is unchanged and the value of the liability does not depend on the allocation policy of the trust fund). As a result, we believe a discount rate based on the EROA is not decision-useful for determining asset allocation.

To be more decision-useful in this context, the discount rate should be independent of the EROA, such as one based solely on fixed income yields.⁸ With this method, plans would not measure their funded status as if the equity risk premium were guaranteed in advance. Rather, funded status would increase or decrease based on actual, not expected investment performance, and would only do so after such performance occurs.

Example 4: Pension Obligation Bonds

Under the GASB's drafts, issuing debt and funding the plan with investments in equities (which typically have higher expected returns than the rate of governmental borrowing) immediately improves the plan sponsor's balance sheet because of the difference between the yield on the debt offering and the expected return on assets. In reality, selling bonds and buying the same amount of stocks neither creates nor destroys net resources immediately (excluding transaction costs) and will only create or destroy net resources to the extent the equities perform better or worse than the interest on the debt. By reporting this accounting arbitrage as an immediate improvement in financial results, however, the drafts encourage plan sponsors to engage in

⁸ Additional details on this point are provided in our response to the GASB's 2009 Invitation to Comment, available at the following link: http://www.actuary.org/pdf/pension/gasb_aug09.pdf.

transactions that are without economic value. Such transactions are tantamount to buying stocks on margin and recognizing the expected gain immediately.

The two-tiered discount rate structure proposed by the GASB would create an oddity in structure in which contributing \$1 to an underfunded plan would affect the net pension liability (NPL) by an amount greater than \$1, as it would both increase the assets and decrease the liabilities. While actuaries are enthusiastic about reducing pension underfunding, it should not be accomplished through a system of flawed accounting metrics.

To be more decision-useful and allow more faithful assessment of interperiod equity, the discount rate should be independent of the EROA, such as discounting the entire liability based on fixed income yields.

These four examples illustrate how discounting the pension obligation using the EROA tends to mislead users, encourage unnecessarily generous compensation, discourage appropriate risk-management of investments and encourage transactions that have no intrinsic economic value. For these reasons, other accounting standards boards have been moving away from using the EROA as the discount rate and instead are using fixed income yields.

5/6. Do you agree or disagree with the GASB's proposals regarding when the factors that affect pension expense should be incorporated into the expense calculation? Why do you agree or disagree?

Changes in the NPL on account of experience, changes in assumptions, and plan changes should be recognized in the balance sheet immediately, but separately from the compensation costs of the plan (e.g., cost attributable to benefits earned during the reporting period). We are pleased to see that the drafts adopts this approach for most changes and has limited the extent to which deferral of gains and losses is allowed.

The deferral of changes in NPL related to experience and changes in assumptions for active employees is not ideal, as such changes have already taken place and the corresponding economic impact should be recognized immediately. The limitation of these deferrals to the active employment period for active employees, however, is a promising first step.

The deferral of gains and losses related to returns on assets different from those expected does not recognize the economic reality of the plan's actual experience at the time the expense is measured. We prefer immediate recognition but recognize the shortened period of deferral as a positive step toward this ideal.

7/8. Do you agree or disagree with the GASB's proposals that governments in cost-sharing multiple-employer plans report a liability equal to their long-term proportionate share of the collective net pension liability? Why do you agree or disagree?

No comment.

9/10. Do you agree or disagree with the GASB's proposals regarding note disclosures and RSI? Why do you agree or disagree?

The drafts call for disclosure of information which will serve GASB's objectives of being useful to the users of financial statements, helpful in the assessment of accountability and conducive to inter-period equity. Lacking a measure of the total pension obligation based on market-consistent inputs in the financial statements themselves, disclosing this information in the notes or the required supplemental information (RSI) would dramatically improve the standard with regard to GASB's objectives. In addition, we are in favor of providing information on contribution policy and strategy, assumptions related to contribution strategy (included expected rates of return on assets), anticipated contribution amounts and history of actual contributions relative to policy in the note disclosures.

11/12. Do you agree or disagree with the GASB's proposals regarding special funding situations? Why do you agree or disagree?

No comment.

13/14. Do you agree or disagree with the GASB's proposals regarding governments participating in defined contribution pension plans? Why do you agree or disagree?

No comment.

The Pension Finance Task Force appreciates the opportunity to comment on these important GASB statements. Despite our areas of disagreement, we commend the board and staff for the effort to improve the public pension standards. The current state of the economy and the failure of both investment return and contribution levels to meet earlier stakeholder expectations have provided new perspective on this task. The separation of pension accounting measurement from pension funding is significant. The actuarial profession is stressing the value of risk management and is intent on developing measures of risk in its various practice areas. We look forward to future opportunities to work with the GASB and would be happy to clarify our comments or provide other technical assistance as the GASB deliberates further.

Sincerely,



R. Evan Inglis, FSA, FCA, MAAA
Chair, Joint SOA/Academy Pension Finance Task Force
American Academy of Actuaries

Response from the Public Plans Subcommittee

The Academy of Actuaries 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 drafts and the preliminary views documents, as well as the invitation to comment. Our comments focus on the extent to which we believe the 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 year 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 inter-period equity with respect to the funding of the pension benefits.

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 drafts would require a 10-year schedule in the required supplementary information comparing actual employer contributions to actuarially calculated employer contributions,⁹ "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.

⁹ 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 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

121,817

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 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 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 percent. 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 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 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 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 percent change in TPL for a 1% change in discount rate, would be as follows:

	<u>1% Decrease (6.75%)</u>	<u>Current Assumption (7.75%)</u>	<u>1% Increase (8.75%)</u>
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 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.

Sincerely,

A handwritten signature in blue ink that reads "William R. Hallmark". The signature is written in a cursive style with a prominent initial "W".

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