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September 17, 2010

Director of Research and Technical Activities
Project No. 34
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
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To: Director of Research and Technical Activities, Project No. 34

The attached comments were developed through the coordinated efforts of members of the Conference of Consulting Actuaries' (CCA) Public Plans Committee and are being submitted to the GASB by the Steering Committee of the CCA Public Plans Committee. However, these comments do not necessarily reflect the views of the CCA, the CCA's members, or any employers of CCA members, and should not be construed in any way as being endorsed by any of the aforementioned parties.

The members of the CCA Public Plans Committee represent a broad cross section of public-sector actuaries whose extensive experience with public plans provides the framework for our response. The membership includes over 50 leading actuaries whose firms are responsible for cost and liability measurements for the majority of public sector retirement systems. We believe the overall response reflects a substantial consensus among the actuaries who provide valuation and consulting services to public pension plans. We also believe the comments and recommendations made below would improve the final standards by providing a coordinated approach to the pension funding and accounting measures used by state and local governments in a manner consistent with both model actuarial practice and the conceptual goals of financial accounting and reporting.

We are grateful to the GASB for issuing the Preliminary Views (PV) and inviting public-sector actuaries and others to comment on these important issues. The Board's willingness to prepare a Preliminary Views document rather than an Exposure Draft demonstrates its commitment to an open and constructive deliberation process. We are also grateful to the Board and project staff for their hard work in striving to understand these complicated and interconnected issues. We also ask that a representative of our group be allowed to participate in the GASB's hearing in San Francisco on October 14, 2010.

Paul Angelo, FSA, FCA, MAAA, EA (By Direction)
Chair of the Public Plans Committee on behalf of the
Public Plans Steering Committee

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Steering Committee of the Conference of Consulting Actuaries Public Plans Committee [1]

Response to the Preliminary Views of the GASB on
Pension Accounting and Financial Reporting by Employers
September 17, 2010

Areas of Agreement

Long-term Perspective. We agree with the GASB's view that a distinguishing feature of governments is their long-term nature. We also agree that one implication of this is that governmental financial statements are not used to determine whether a government will continue to exist. Rather, as discussed in the PV, the information is used to gain insight into the sustainability of services provided by the government and the government's ability to meet future service demands. (PV Chapter 1, paragraph 15) Moreover, we agree that this long-term view is "consistent with focusing on trends in operations, rather than on short-term fluctuations." (PV Chapter 1, paragraph 15)

Cost of Services Perspective. We also agree this leads logically to a "cost of services" perspective, in which the long-term, ongoing nature of governments and the long-term cost of services is used to determine pension accounting and financial reporting measures. With regard to pension accounting, a prominent implication of this long-term perspective is that "employment-exchange transactions should be viewed in the context of an ongoing, career-long employment relationship." (PV Chapter 1, paragraph 16) This is a key reason why the Board chose the entry age actuarial cost method as the basis for determining the net pension liability, as well as for deciding that the service cost component of the pension expense should be determined as a level percent of payroll.

Interperiod Equity

Implicitly, the Preliminary Views recognize this level cost of services approach as consistent with interperiod equity, and focus on what might be considered long-term interperiod equity, or intergenerational equity. This aspect of interperiod equity is addressed by demographically matching current period inflows of resources with current period costs of services. This perspective is evident in the Board's decision to attribute the cost of benefit changes as well as other changes in net pension liability over active members' remaining service lives.

While we agree this is an important aspect of interperiod equity, we also believe that, particularly for pension obligations, there is another important aspect of interperiod equity that should also be incorporated into pension accounting and financial reporting. To be equitable to taxpayers across different reporting periods, governments should not have to incur extraordinarily large or small pension expense amounts in single periods because of sudden changes or remeasurements in the long-term cost of their pension obligations. This requires attribution methods that manage the extent to which extreme, short-term volatility is attributed to single periods.

For example, it would be inequitable for the full cost (or even a large portion) of the 2008-2009 financial market losses to be borne by taxpayers in a single year. Similarly, it would be inequitable for a large market gain to be recognized immediately in the financial statements. The same is true of assumption changes; it is clearly inequitable for one year of taxpayers to incur the entire cost of a revision in the estimated cost of such a long-term obligation. Consequently, to attribute costs in a way that best meets the goals of both long-term and short-term interperiod equity, it is necessary to balance demographic matching of inflows and outflows with methods specifically designed to manage the impact of cost volatility.

[1] These comments were developed through the coordinated efforts of members of the Conference of Consulting Actuaries' (CCA) Public Plans Committee and are being submitted to the GASB by the Steering Committee of the CCA Public Plans Committee. However, these comments do not necessarily reflect the views of the CCA, the CCA's members, or any employers of CCA members, and should not be construed in any way as being endorsed by any of the aforementioned parties.

We note that the appropriateness of balancing long-term and short-term interperiod equity applies equally well to measures of both accounting cost and funding cost. That is one of the reasons we recommend that the GASB incorporate both of these aspects of pension cost – accounting and funding – in their standards.

Relationship between Pension Accounting and Pension Funding

Before we respond to the specific questions posed in the Preliminary Views, we wish to express our concerns over the complete separation of pension funding and accounting measures proposed in the Preliminary Views. As stated in our response to the GASB's Invitation to Comment, we believe the financial reporting objectives of accountability, decision-usefulness, and interperiod equity are best achieved when the focus is on the process by which the employer funds the plan. While this does not necessarily means that each year's accounting cost and funding cost will be equal, we believe that a complete separation between the measures of accounting and funding impairs accountability and the usefulness of the information for making decisions.

If such a separation is made, it should be based on compelling arguments for such a substantial change. We do not believe such compelling arguments were presented in the Preliminary Views. We next discuss the compelling practical arguments against such a separation, followed by why, even from a theoretical standpoint, such a complete separation is neither necessary nor justifiable.

Usefulness of the Annual Required Contribution Measure. For over a decade, the annual required contribution (ARC) and the related annual pension cost (APC) have based the pension expense on a measure that reflects the actuarially determined contributions necessary to fund benefits. This clear relationship between funding and accounting has made it easy to assess the employer's accountability with regard to funding the benefits. To do so, financial report users need only look at the net pension obligation (NPO) to see whether the employer has consistently paid the ARC each year.

In addition, maintaining the link between funding and accounting is also useful for informing a variety of decisions related to pensions that were referenced in the ITC, including determining:

- the contributions needed to fund the benefits over time;
- the extent to which progress toward full funding is being made over time; and
- the actuarial assumptions used to determine the contributions needed to fund benefits.

The usefulness of this information is demonstrated by the extent to which the NPO and ARC have been referenced in many studies of public pension plans over the past two decades conducted by federal and state oversight bodies, national associations, credit rating agencies, and private consulting firms. Because (as discussed below) the new expense measure proposed in the Preliminary Views is no longer a viable basis for funding, the financial statement user will no longer be able to assess employer accountability for funding the pension obligation.

Difficulty Reconciling Accounting and Funding. The measures proposed in the Preliminary Views would no longer bear any useful relationship to the corresponding funding measures. The net pension liability (NPL) would be based on the market value of assets, making the NPL substantially different and more volatile than the unfunded actuarial liability on which funding is based. Even more importantly, the measure of pension expense would amortize both actuarial gains and losses and assumption changes too rapidly to be used as a basis for an actuarially determined contribution. As a result, it would be very difficult to reconcile the GASB's proposed pension accounting measures with the funding measures. This would leave financial report users wondering why the two measures are different and which one measures the "real" pension cost. Consequently, rather than promoting transparency, the new measures would likely be a source of confusion and even misinformation.

Level Cost of Services Framework

We maintain that the long-run cost of services for pension benefits is the funding cost. Theoretically, the cost of services for accounting purposes should ultimately be the same as the cost of funding, since ultimately it is the funding requirements that determine the costs actually borne by taxpayers to support the pension obligation. If the pension expense does not ultimately reconcile with the contributions required over the long run, it would be fair to ask what "cost" it does measure.

However, even if there is a conceptual basis for an accounting cost separate from the funding cost, the Preliminary Views themselves lead to the conclusion that these two measures should be closely related. This result follows from the GASB's own resolution of a substantive and much-discussed dispute as to the measurement of public pension liabilities. As ably argued in the Preliminary Views, the GASB has chosen a level cost of services approach (using a level percentage of payroll attribution method and a long-term expected rate of return discount rate) over a fair or market value approach (using a present value based attribution method and a market interest discount rate).

Given that the Preliminary Views supports this level cost of services approach when determining the annual service cost of the pension obligation, we recommend that the same approach be extended to the attribution of the cost of *variations* in the measurement that service cost, variations that are inherent in the deferred nature of a pension promise. As we will discuss in our response to the specific issues and questions in the Preliminary Views, this entails taking a level cost approach to the recognition of actuarial gains and losses (including investment gains and losses) and of assumption changes. This level cost approach to variations in cost also supports the short-term aspect of interperiod equity that was discussed earlier

Level Cost of Service Framework Components. To be effective in achieving the goals of level cost and interperiod equity, a level cost of services approach must address both the estimation of a service cost and the attribution of variations around that service cost. In practice, this requires a framework of three components: (1) the service cost attribution method; (2) a method for managing the level of volatility uniquely associated with investment performance; and (3) a method for managing unexpected changes in the unfunded actuarial liability (analogous to changes in GASB's Net Pension Liability or NPL). An essential aspect of this framework is that in component (3) the changes in unfunded liability include not only changes in liability due to liability gains and losses and assumption changes, but also changes in the volatility-managed or "smoothed" asset value from component (2). This differs from the framework in the Preliminary Views and is required by the empirical fact that short term investment volatility is so much greater than any other source of cost volatility.

This level cost of services framework is essential to the actuarial science of modeling the cost of long-term pension promises and so provides the basis for our responses to the issues and questions raised in the Preliminary Views.

Responses to the GASB's Questions

<u>Issue 1—An Employer's Obligation to Its Employees for Defined Pension Benefits</u>

Question 1: *It is the Board's preliminary view that, for accounting and financial reporting purposes, an employer is primarily responsible for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits. Do you agree with this view? Why or why not?*

For the reasons discussed in the Preliminary Views, we generally agree that the employer is primarily responsible for the portion of the defined benefit obligation in excess of plan net assets available for benefits.

Issue 2—Liability Recognition by a Sole or Agent Employer

Question 2a. *It is the Board's preliminary view that the unfunded portion of a sole or agent employer's pension obligation to its employees meets the definition of a liability (referred to as an employer's net pension liability). Do you agree with this view? Why or why not?*

While we generally agree that the net pension liability meets the Concept Statement 4 definition of a liability, we have serious concerns about it being sufficiently reliable to be recognized in the employers' basic financial statements.

Question 2b. *It is the Board's preliminary view that the net pension liability is measurable with sufficient reliability to be recognized in the employer's basic financial statements. Do you agree with this view? Why or why not?*

We disagree and believe recognizing the NPL in the employer's basic financial statements could be seriously misleading and result in unstable and unreliable financial statements. We recommend that if any form of the NPL is recognized in the basic financial statements, it should be based on a volatility-managed or "smoothed" market-related value of assets.

Market Value of Assets. For the basic financial statements, basing the NPL on the market value of assets is inconsistent with the Board's recognition of the long-term nature of governments. If a liability as potentially large and volatile as this NPL is recognized in the basic financial statements, it should be measured in a way that represents the long-term nature of the obligation. This could be achieved by basing the NPL on a smoothed value of assets, which would defer recognition of short-term market volatility, while still maintaining a close relationship to the market value over the long term. We discuss asset smoothing further in our response to Question 4b.

An NPL based on the market value of assets should still be part of the employers' reporting in the notes to the financial statements, along with additional explanatory information on the effect of asset smoothing on future costs and liabilities. However, an NPL based on the market value of assets is not consistent enough from period to period to be a sufficiently reliable measure of liability for such a long-term obligation.

Impact on an Employer's Statement of Net Assets. While the GASB may view the definition of reliability as limited to the reliability of measurement, we ask the Board to consider how including the NPL in the employer's basic financial statements could undermine the reliability of the financial statements themselves. It is likely the NPL would be the largest item on the government's Statement of Net Assets (SNA), so large as to distort the SNA relative to other operations.

Moreover, changes in the NPL due to changes in assets or actuarial assumptions could dramatically change financial statement net balances and financial ratios. This, in turn, could result in the violation of bond covenants or force some governments into financial emergencies.

Put another way, because the NPL is based on the market value of plan assets, it would be highly volatile in a manner inconsistent with other items on the SNA. In essence, the NPL would drive the government's bottom line, and obscure the effects of other assets and liabilities.

Net Pension Assets. It is also likely that pension assets will exceed pension liabilities in some future years. If so, this would create a negative NPL, or Net Pension Asset (NPA). Presenting an NPA in the basic financial statements would invite the interpretation that the employer has an additional asset to apply towards other obligations, assets that in fact are held in the pension trust for the exclusive benefits of participants. Since, by law, the employer actually has no access to those assets, this would not only be misleading, it would be incorrect.

Transition and Other Issues. There are other issues to consider. First, what is the transition strategy? How will the NPL be added to the SNA? What other employer assets or liabilities will be affected? How should financial statement users understand this dramatic change in financial statement net balances and financial ratios? Second, how will financial statement users interpret potentially dramatic year-to-year changes in financial statements resulting from large changes in the NPL due to investment experience, other actuarial experience and assumption changes. These are critical, conceptual issues that should be addressed as part of the decision to recognize the NPL in the basic financial statements, and not left as details of implementation.

Issue 3—Measurement of the Total Pension Liability Component of the Net Pension Liability by a Sole or Agent Employer

Question 3a. *It is the Board's preliminary view that the projection of pension benefit payments for purposes of calculating the total pension liability and the service-cost component of pension expense should include the projected effects of the following when relevant to the amounts of benefit payments: (1) automatic cost-of-living adjustments (COLAs), (2) future ad hoc COLAs in circumstances in which such COLAs are not substantively different from automatic COLAs, (3) future salary increases, and (4) future service credits. Do you agree with this view? Why or why not?*

We agree. We strongly support the Board's view that the pension liability and expense should be based on projected salaries, service, and automatic COLAs, which is consistent with the GASB's conclusion that these measures should reflect employees' career-long relationships with the employer. Generally, we support including any automatic arrangements that are part of the substantive plan (e.g., automatic gain sharing, Deferred Retirement Option Programs (DROPs), etc.).

Question 3b. *What criteria, if any, do you suggest as a potential basis for determining whether ad hoc COLAs are not substantively different from an automatic COLA and, accordingly, should be included in the projection of pension benefit payments for accounting purposes?*

We suggest that determining whether an ad hoc COLA is substantially different from an automatic COLA should reflect the basis, process, and authority for granting the COLAs, as well as their past frequency and consistency. This might lead to actuarial assumptions regarding the amount and frequency of the ad hoc COLA (e.g., 3 out of 5 years).

Question 3c. *It is the Board's preliminary view that the discount rate for accounting and financial reporting purposes should be 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 assets 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 assets available for pension benefits are projected to be fully depleted. Do you agree with this view? Why or why not?*

We agree. We strongly support the approach proposed by the Board, which recognizes that "the employer's projected sacrifice of resources is effectively modified (reduced) by the expected return on investments" (PV Chapter 4, paragraph 16). However, we offer the following comments and recommendations as to its implementation:

Projected Future Contributions. With regard to contributions included in current and expected future plan net assets, we agree they should include "projected future contributions from all sources related to funding the benefits of employees currently in the plan…" (PV Chapter 4, paragraph 17) However, we recommend that the Board clarify that these contributions could include payments toward the current unfunded liability even if they are based on future payrolls that include new plan members, as long as contributions to fund service cost for those new members are excluded.

Municipal Bond Index Rates. With regard to municipal bond index rates, we recommend that the index rates reflect taxable bond yields. These are the rates at which pension obligation bonds would be issued and so represent the appropriate valuation of this portion of the obligation. In order to minimize the volatility in the rates, we recommend the use of monthly index rates averaged over at least one business cycle (5 to 7 years).

We also note that in years of high inflation, there is a possibility that the single equivalent discount rate would be higher than the long-term expected return, resulting in a total pension liability that is made *lower* as a result of the insufficiency of projected assets. We believe this is a clearly unintended consequence that could also be mitigated by the use of monthly index rates averaged over 5 to 7 years.

Cost for Small Employers. We are also concerned that the costs associated with performing the projections needed to determine the single equivalent rate would be burdensome for small employers. Consequently, we recommend that the standards allow employers with less than 100 total plan members to use the long-term expected return if (1) they have a history of making their full actuarially determined contributions in accordance with a stated contribution policy and (2) the value of current assets plus the present value of future contributions (in accordance with that contribution policy) equals the present value of future benefits.

Question 3d. *It is the Board's preliminary view that for purposes of determining the total pension liability of a sole or agent employer, as well as the service-cost component of pension expense, the present value of projected benefit payments should be attributed to financial reporting periods over each employee's projected service life using a single method—the entry age actuarial cost method applied on a level-percentage-of-payroll basis. Do you agree with this view? Why or why not?*

We agree. We strongly support the Board's view that the pension liability and expense should be based on a level cost attribution method, consistent with the GASB's conclusion that these measures should reflect the employee's career-long relationship with the employer.

Issue 4—Attribution of Changes in the Net Pension Liability to Financial Reporting Periods by a Sole or Agent Employer

Question 4a. *It is the Board's preliminary view that the effects on the net pension liability of changes in the total pension liability resulting from (1) differences between expected and actual experience with regard to economic and demographic factors affecting measurement, (2) changes of assumptions regarding the future behavior of those factors, and (3) changes of plan terms affecting measurement should be recognized as components of pension expense over weighted-average periods representative of the expected remaining service lives of individual employees, considering separately (a) the aggregate effect on the liabilities of active employees to which the change applies and (b) the aggregate effect on the liabilities of inactive employees. Do you agree with this view? Why or why not?*

While we agree with the approach for attributing plan changes, we disagree with the approach for attributing experience gains/losses and assumption changes.

Attributing Plan Changes. We believe that changes in plan terms are fundamentally different from experience gains/losses and assumption changes. Plan changes are within the control of the employer and result in a resetting of benefits. Experience gains/losses and assumption changes do not change existing benefits and only remeasure the costs; moreover, as discussed in our introduction, they require considerations of volatility management that are generally not appropriate for benefit changes. Consequently, we agree with the Preliminary Views approach for attributing the effect plan changes on the NPL. However, we recommend a different approach for attributing experience gains/losses and assumption changes, as discussed below.

We do suggest that early retirement incentives are a special type of plan changes, in that (1) they involve the transition of members from active to inactive status and (2) they are often implemented to achieve specific financial advantages for the employer. For those reasons we recommend an attribution period related to the anticipated economic impact on the employer, but not longer than 5 years.

Attributing Experience Gains/Losses and Assumption Changes. For attributing experience gains/losses and assumption changes, we believe the approach described in the Preliminary Views (especially for inactive members) is fundamentally inconsistent with both interperiod equity and with the Board's view that the pension expense should bear a consistent relationship to salary levels.

As discussed in our introduction, we believe interperiod equity requires consideration of short-term, period-to-period equity, as well as long-term intergenerational equity. By requiring experience gains/losses and assumption changes to be immediately recognized for inactive members, the proposed expense will be made extremely volatile. As examples, in our introduction we described the extraordinarily volatile impact on a single period of expense caused by large investment gains or losses, as well as by assumptions changes for inactive member liabilities. Another harmful policy effect is that the proposed attribution rules could discourage plans and plan sponsors from adopting actuarially justified assumption changes, because they would be forced to expense the entire, long-term impact in a single period.

The short or immediate recognition of experience gains/losses and assumption changes is also inconsistent with the level cost approach. Because a pension plan is a promise of deferred income, pension costs are necessarily estimates that must be remeasured periodically, even after a member's service is completed. Under a level cost approach, experience gains/losses and assumption changes should be treated in a manner consistent with the original, level cost development of the service cost. This cannot be achieved under a rigid requirement that the ultimate cost of each member's benefit be expensed over that individual's active service.

These two related considerations of volatility management and a level cost of services require relaxing the goal of matching each period's inflows of resources with its cost of services. That leads to the balancing of demographic matching and volatility management that was discussed in our introduction.

We recommend that experience gains/losses and assumption changes be attributed so as to promote interperiod equity by avoiding undue volatility in the pension expense. This is achieved by using an attribution period that balances shorter, demographically based periods with longer periods that manage volatility. Our experience with many plans over many years and conditions, indicates that attributing experience gains/losses and assumption changes as a level percentage of payroll over an attribution period of 15 to 20 years will accomplish this balance. The use of a 15 year period will also assure a minimum attribution of interest on the beginning-of-year liability.

This attribution approach has the additional advantage that it is also a disciplined yet viable basis for funding. This could provide a framework for a coordinated approach between pension expense and an actuarially determined contribution (ADC), where the ADC would allow for a range of attribution periods and the pension expense would be based on a single point in the range (most likely the shorter end). The following table provides suggested periods for expensing and funding under such a framework:

Source	Expensing	Funding
Active Plan Amendments	Demographic	Demographic
Inactive Plan Amendments	1 year	Demographic
Experience Gain/Loss	15	15 to 20
Assumption Changes	15	15 to 25
Early Retirement Incentives	5 or less	5 or less

We also recommend a minimum expense equal to the service cost less asset surpluses (if any) amortized over a 30 year period.

The development of these recommended periods is a relatively recent advance in actuarial practice, and goes beyond the scope of these responses. We would appreciate the opportunity discuss the development of this and other aspects of the level cost of services framework with the Board and its staff.

Question 4b. *It is the Board's preliminary view that the effects on the net pension liability of projected earnings on plan investments, calculated using the long-term expected rate of return, should be included in the determination of pension expense in the period in which the earnings are projected to occur. Earnings on plan investments below or above the projected earnings should be reported as deferred outflows (inflows) unless cumulative net deferred outflows (inflows) resulting from such differences are more than 15 percent of the fair value of plan investments, in which case the amount of cumulative deferred outflows (inflows) that is greater than 15 percent of plan investments should be recognized as an increase or decrease in expense immediately. Do you agree with this view? Why or why not?*

We disagree for the following reasons:

The proposed approach would result in the erratic and inconsistent recognition of asset gains/losses in a manner that is not compatible either with the long-term nature of governments or with a long-term, level cost of services approach. Moreover, it is does not support interperiod equity, since it would ignore market gains and losses during some periods and then in other periods require large market gains and losses to be attributed to taxpayers in a single year. This will disproportionately burden taxpayers in some years and advantage them in others.

The proposed approach is a particular type of "asset smoothing" that begins by deferring market gains/loss (relative to the long-term earnings assumption) for an indefinite period. Since this value will not necessarily bear any long-term relationship to market value, a separate "corridor" constraint is needed to achieve that relationship.

As discussed in the Preliminary Views, the Board based this approach on the belief that recent past investment experience will be offset by future experience. In practice, while future returns are expected to average out to the expected returns, this does not mean future returns can be counted on to offset recent past experience in the short-term. That is why the preferred practice is to have a "return to market" condition as part of the smoothing method. This means that, even if future returns *only* average out to the expected return, the smoothed value will still return to the market value over a short period.

The most common "return to market" condition is to recognize each year's market gain/loss over a fixed period of years (the "smoothing period"). This in turn greatly reduces the need for a separate corridor or other constraint to keep the smoothed value within a reasonable range of market value. That is because the two values will converge whenever the assets actually earn the assumed earnings rate for a few years. The key is that, for this to happen, it is no longer necessary for future returns to offset recent experience; they only have to match the assumed earnings rate.

Our last technical observation comes from the actuarial standard of practice that governs asset values for pension plans, whether for funding or accounting. ASOP No. 44 describes the relationship between smoothing periods and corridors; in particular if the smoothing period is sufficiently short, there may not be a need for any corridor at all.

As discussed in our response to Issue 2b, we recommend that the NPL be based on a smoothed value of assets in order for it to be measureable with sufficient reliability to be reported in the basic financial statements. In particular, we recommend that each year's investment gains and losses (relative to the long-term expected rate of return) should be recognized in the smoothed value (and thereby in the NPL) over a five year period. We further recommend that five years should be considered sufficiently short so that no market value corridor constraint is required.

As discussed in our introduction, an effective level cost of services framework must incorporate the fact that short term investment volatility is by far the greatest source of cost volatility for a pension plan. This means that asset smoothing alone is not sufficient to achieve either interperiod equity or a relatively level long-term cost of services.

In this framework, the reason that the NPL is based on a smoothed asset value (rather than market value) is to have an NPL where the year-to-year changes in the NPL due to investment return (after smoothing) are comparable in size to the year-to-year experience gains/losses in the liability component of the NPL. This allows all changes in NPL due to differences between actual and expected experience to be expensed over the same attribution periods.

We recommend that changes in NPL due gains/losses on the smoothed value of assets be attributed to expense in the same manner and over the same periods as liability gains/losses, as discussed in our response to Issue 4a.

We acknowledge that means that investment return is subject to two types of volatility management, and that this is fundamentally different from the Preliminary Views framework as presented in Issues 4a and 4b. We repeat that this is a necessary feature if the level cost of services framework is to accommodate investment volatility, which is substantially more volatile than any other element of plan experience. We would appreciate the opportunity discuss this aspect of the level cost of services framework with the Board and its staff.

Issue 5—Recognition by a Cost-Sharing Employer

Question 5a. *It is the Board's preliminary view that each employer in a cost-sharing plan is implicitly primarily responsible for (and should recognize as its net pension liability) its proportionate share of the collective unfunded pension obligation, as well as its proportionate share of the effects of changes in the collective unfunded pension obligation. Do you agree with this view? Why or why not?*

We disagree for the following reasons:

The Board's presentation of their views on employers in cost-sharing plans is an extension of their views for employers with sole or agent employer plans. However, even though the Board recognized the characteristic differences between these types of plans, they did not consider that their proposed approach for employers in cost-sharing plans is contrary to the implicit design of a cost-sharing plan, and to its definition. As defined in GASB Statement No. 27, a cost-sharing plan is (emphasis added):

> "A single plan with pooling (cost-sharing) arrangements for the participating employers. All risks, rewards, costs, including benefit costs, **are shared and are not attributed individually to the employers.** A single valuation covers all plan members and the same contribution rate(s) applies to each employer."

We suggest that the following excerpts from the GASB Statement No. 27 Basis for Conclusions (paragraphs 173-177) are more persuasive than the views of the Board in Chapter 6 of the PV.

- "Respondents indicated that it would be neither conceptually justifiable nor practical to require cost-sharing employers to recognize pension expenditures/expense for an amount other than their contractually required contributions." (paragraph 173)

- "The obligation or commitment for benefits is not directly attributable to any individual participating employer; any attribution would be arbitrary." (paragraph 175)

- "Therefore, this Statement requires cost-sharing employers to recognize pension expenditures/expense equal to their contractually required contributions and a liability to the plan for contributions due and unpaid. A large majority of the respondents to the ED of this Statement, Statement 25, or both supported the Board's conclusions concerning financial reporting by cost-sharing employers and plans." (paragraph 177)

In light of the conceptual inconsistency and practical complications of attributing NPL and changes in NPL to employers in a cost-sharing plan, we recommend that the Board continue the requirements of GASB Statement No. 27 as they apply to cost sharing plans.

Question 5b. *The Board is considering basing the determination of proportionate shares of the collective net pension obligation on employers' respective shares of the total annual contractually required contributions to the plan and believes that would provide a reliable basis for measurement. However, the Board is seeking constituent input regarding other potential bases that might exist for this determination. What basis, if any, do you suggest for determining a cost-sharing employer's proportionate share of the collective net pension obligation?*

We disagree that a proportionate share of the net pension liability and pension expense should be allocated to cost-sharing employers for the following reasons:

The Board believes (1) that each cost-sharing employer is primarily responsible for its "implicit share of the pooled benefit risks and plan assets", and (2) that, therefore, "each cost-sharing employer should recognize its proportionate share of the collective net pension liability."

The Board indicates that they have not finalized the method that should be used for the attribution process. We suggest that there is no relatively simple method that would result in an allocated implicit share that would be a "sufficiently reliable measure" for recognition as a liability in the financial statements of each individual cost-sharing employer.

The Board suggests that some measure of the employer's net pension liability and pension expense would be better than no measure at all. However, this would not be the case if the resulting measure was misleading. We believe that in the most cases, the pension expense attributed to an employer under the Preliminary Views approach would be different from the employer's contractually required contribution, which is the employer's legally required payment to the plan. To suggest that the employer has an expense that is different from its legal liability would be misleading to users of the financial statements. In addition, the employer would have no means of paying a higher or lower contribution to cover this expense, even if desired. For the employer to become responsible for a higher or lower contribution would first require that the contractually required contribution be changed by the appropriate governing body.

In addition, the net pension liability and pension expense for a participating employer could be significantly affected by events unrelated to the participating employer or its plan members. For example, assume there are two employers in a cost-sharing plan. One is a mature employer in a declining population base and the other is a newly created entity. As a result of these demographics, Employer 1 has one-third the employees of Employer 2, but all the retirees receiving benefits under the Plan are former Employer 1 employees. The cost-sharing plan's $1,000 net pension liability and $100 pension expense are allocated between employers based on their proportionate shares of the contractually required contributions, and that the contractually required contributions are assessed as 10% of active member payroll.

In Year 1, Employer 1 has a payroll of $250 and Employer 2 has a payroll of $750. So in Year 1:

- Employer 1's contractually required contribution is $25 (10% x $250) and
- Employer 2's contractually required contribution of $75 (10% x $750).

As a result:

- Employer 1's proportionate share of the contractually required contribution is 25% ($25 / ($25 + $75)) and
- Employer 2's proportionate share is 75% ($75 / ($25 + $75)).

Consequently:

- Employer 1 would recognize an NPL of $250 (25% x $1,000) and pension expense of $25 (25% of $100).
- Employer 2 would recognize an NPL of $750 (75% x $1,000) and pension expense of $75 (75% of $100).

In Year 2, assume everything remains the same except the legislature approves an ad-hoc COLA for retirees of the Plan.

- The NPL increases by 2% which translates into an increase in pension expense of $20 (2% x $1,000).
- Employer 1's pension expense would be $30 (25% x $120) while
- Employer 2's pension expense would be $90 (75% x $120)

The result is that, even though none of the increased expense was due to Employer 2's participation in the Plan, Employer 2 would experience an increase in pension expense of 20% ($90/$75 – 1). It is difficult to see how this would meet the standard of being "reliably measurable".

Again, we recommend that the Board continue the requirements for cost-sharing employers as presented in GASB Statement No. 27.

Issue 6—Frequency and Timing of Measurements

Question 6. *The Board's preliminary view is that a comprehensive measurement (an actuarial valuation for accounting and financial reporting purposes) should be made at least biennially, as of a date not more than 24 months prior to an employer's fiscal year-end. If the comprehensive measurement is not made as of the employer's fiscal year-end, the most recent comprehensive measurement should be updated to that date. Professional judgment should be applied to determine the procedures necessary to reflect the effects of significant changes from the most recent comprehensive measurement date to the employer's fiscal year-end. Determination of the procedures needed in the particular facts and circumstances should include consideration of whether a new comprehensive measurement should be made. Do you agree with this view? Why or why not?*

While we agree with the goal of obtaining timely measures, we believe there are many practical difficulties with obtaining pension reporting information at each employer's fiscal year-end. We recommend that the GASB conduct a realistic appraisal of the practical effect of any proposed changes to the frequency and timing of both asset and liability measurements. Such an appraisal should explicitly consider the ability to determine the pension expense on a timely basis, as well as the effect on pension expense of any changes in balance sheet measurements that occur during or after the fiscal year for which the expense is determined.

The following discussion and proposals reflect an intent to allow the employer to budget for the pension expense before the beginning of the fiscal year, including the opportunity to make contributions during the year that are consistent with the pension expense for the year. We recommend that any practical approach to measurement and timing should accommodate these goals.

Liability Measurements. For liability measurements where the plan and employer fiscal years coincide, actuarial valuations are typically done two years before the end of the related fiscal year. For example, a June 30, 2010 valuation would determine the NPL and pension expense for the employer's fiscal year starting July 1, 2011 and ending June 30, 2012 (2011/2012). Consequently, by the time an employer's FYE 2012 financial statements are being prepared, the June 30, 2011 valuation may already be completed.

Under the GASB's proposed rules, the employer would be required to use the new June 30, 2011 valuation. However, basing the June 30, 2012 NPL on the June 30, 2011 valuation would either (1) require remeasurement of the 2011/2012 pension expense after the year has commenced or (2) require inconsistent expense and balance sheet results for the

2011/2012 statements. Moreover, the availability of the intervening valuation (e.g. the June 30, 2011 valuation in this example) could vary from year to year leading to an inconsistent series of disclosures.

Asset Measurements. In the example above, requiring a June 30, 2012 asset value for the FY 2011/2012 financial statements would mean the resulting NPL would not be known until after the end of the 2012 fiscal year. This was practical when the NPL was only a note disclosure. If the NPL is now on the basic financial statements, any unexpected changes in the June 30, 2010 asset values will affect the pension expense, which again would either:

- Require remeasurement of the 2011/2012 expense after the year has commenced, or
- Require inconsistent expense and balance sheet results for the 2011/2012 statements.

Different Employer and Plan FYE Dates. Generally, reliable pension asset values are often available only as of the plan's fiscal year-end date, which is not compatible with requiring an asset value as of the employer's fiscal year-end date. This is especially problematic for employers in cost-sharing and agent multiple-employer plans, where employers may have many fiscal year-ends. To require assets to be valued as of each employers' fiscal year end date will add significant costs to the valuations, and may not be justified from a cost-benefit perspective.

Recommendations: We recommend the GASB consider more practical approaches, including some elements of the following:

- Use a single valuation date for all employers with roll forward amounts to accommodate different employer fiscal years for multiple employer plans;
- Accept beginning-of-period reporting of the NPL on the basic financial statements, with end of period amounts disclosed in the notes;
- Base balance sheet disclosures on the same liability valuation as was originally used to determine pension expense for the fiscal year, regardless of any intervening valuations;
- Base pension expense on asset values determined before FYE (or even before FYB) even if the later asset values are used in the basic financial statements.

Based on these elements and using the example above, our ideal recommendation would be consistent with current practice, modified to accommodate reporting the NPL on the basic financial statements:

- The 2011/2012 pension expense would be determined based on the June 30, 2010 valuation of both assets and liabilities.
- The NPL for the 2011/2012 fiscal year would be the beginning of period amounts, based on the June 30, 2010 valuation of both assets and liabilities, rolled forward to June 30, 2011. This NPL could be further adjusted to June 30, 2012 but only for pension expense and contributions.

If it is deemed essential to reflect more current assets in the NPL (i.e., to avoid any roll forward of asset values), this approach could be modified in one of two ways:

- Use the actual June 30, 2011 assets to develop the smoothed value of assets together with the rolled forward June 30, 2010 liabilities, for the beginning of period NPL on the 2011/2012 basic financial statements. This NPL could be further adjusted to June 30, 2012 but only for pension expense and contributions. However, any unexpected changes in asset value as of June 30, 2011 would not be reflected in the 2011/2012 pension expense.
- Use the actual June 30, 2012 assets to develop the smoothed value of assets, together with the rolled forward June 30, 2010 liabilities, for the end of period NPL on the 2011/2012 basic financial statements. The June 30, 2010 liabilities would be rolled forward regardless of any subsequent valuation completed in the interim. Any unexpected changes in asset value between June 30, 2010 and June 30, 2012 would not be reflected in the 2011/2012 pension expense.

For employers with fiscal years different from the plan fiscal year:

- Apply the above procedures to the plan year-end preceding the employer's fiscal year-end.
- Roll forward assets and liabilities to the employer' year end, but only for pension expense and contributions. While we appreciate the general desire to avoid any roll forward of asset values, obtaining asset values as multiple year-end dates is not a practical alternative.

To make the above proposals workable for employers with biennial valuations, the maximum period from the valuation date to the end of the employer's fiscal year should be 36 months instead of 24 months. In addition, professional judgment should be allowed, not only for updating the total pension liability but also for determining the appropriate smoothed value of assets.

This discussion and these examples illustrate the complexity of these timing and measurement issues. This is the basis for our recommendation that the GASB conduct a realistic appraisal of the practical effect of any proposed changes with regard to both the asset and liability measurements. Such an appraisal should explicitly consider the ability to determine the pension expense on a timely basis, as well as the effect on pension expense of any changes in balance sheet measurements that occur during or after the fiscal year for which the expense is determined.