California Actuarial Advisory Panel

September 17, 2010

Director of Research and Technical Activities
Project 34
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk CT 06856-5116

Re: Preliminary Views of the Governmental Accounting Standards Board: Pension Accounting and Financial Reporting by Employers

The California Actuarial Advisory Panel (the Panel) appreciates the opportunity to provide the Governmental Accounting Standards Board (GASB) comments on the Preliminary Views for Pension Accounting and Financial Reporting by Employers (Preliminary Pension Views). The Panel was established with the enactment of California Senate Bill 1123 (Chapter 371, Statutes of 2008). Pursuant to Government Code section 7507.2(a):

"*…the panel shall provide impartial and independent information on pensions, other postemployment benefits, and best practices to public agencies…*"

Legislation to create the Panel was recommended by the Public Employee Post-Employment Benefits Commission in a January 2008 report to Governor Schwarzenegger.

The Preliminary Pension Views asked for comments related to six issues:

Issue 1—An Employer's Obligation to Its Employees for Defined Pension Benefits
Issue 2—Liability Recognition by a Sole or Agent Employer
Issue 3—Measurement of the Total Pension Liability Component of the Net Pension Liability by a Sole or Agent Employer
Issue 4—Attribution of Changes in the Net Pension Liability to Financial Reporting Periods by a Sole or Agent Employer
Issue 5—Recognition by a Cost-Sharing Employer
Issue 6—Frequency and Timing of Measurements

The current accounting measures provide valuable information about the long-term cost of the plan – currently embedded in the concept of the Annual Required Contribution (ARC) – and about whether the employer is funding the cost or deferring it into the future – currently embedded in the concept of the net pension obligation. We believe that good financial reporting must provide information that allows readers to assess these two areas and strongly encourage the Board to ensure that any accounting standard still provides this information in some form or another.

The other factor that financial statements should provide information about – the total obligation of the taxpayers to provide for the promised pension benefits – is the area where the current accounting standards are weakest and this should be the focus of any changes to the accounting standards.

However, any improvements in this area should not come at the expense of the ability of the reader to assess the long-term cost of the plan and whether the employer is funding those costs. In order for the reader to assess whether the employer is funding or deferring the costs of the plan, it is necessary to have some linkage between funding and accounting. This does not necessarily mean that accounting has to follow funding. Instead, the accounting standard could set out what a reasonable cost would be for the current period and report whether or not the employer has funded those costs.

Ultimately, accountability and interperiod equity can only adequately be measured based on whether a plan sponsor has or has not made actuarially determined contributions to fund their plan. We are very concerned that recognition of the Net Pension Liability (NPL) and proposed attribution of changes in NPL will result in a pension expense that is not consistent with any reasonable plan funding. This will make it more difficult to measure plan sponsor accountability and assess interperiod equity. As an example, those of us that work in the Other Post-Employment Benefits (OPEB) area are now seeing plan sponsors recognize the importance of pre-funding those obligations. That recognition did not happen before GASB Statement No. 45 and will likely not continue if the preliminary views are applied to OPEB. Similarly, if there are few or no reporting implications to an employer not making pension contributions, in today's economic environment, more pension plan sponsors will consider not making the actuarially determined contribution.

Furthermore, the Panel believes that the concepts of interperiod equity and the employment exchange apply to both accounting and funding. This means that these two measures of pension cost are essentially similar and should be based on the same actuarial methods. Note that the Preliminary Views come to this same conclusion in selecting a level cost attribution method (Entry Age) and discount rate (long-term expected earnings) for plans that are funded on an actuarially determined basis.

The long-term nature, financial measurement, instability, government association and other aspects make public pension plans unique. Because of the unique nature of pension plans and the need to be certain that the information presented is the most useful information possible for the readers and users of financial reports, accounting and actuarial practices and policies must work together. In some situations, they should be reviewed and adjusted as necessary. Just as the GASB is reviewing accounting practices in the pension plan disclosure area, the Panel is beginning a review of current California public plan actuarial practices and polices. The Panel would be please to work with the GASB to arrive at disclosure rules that blend any new accounting and actuarial practices.
We appreciate the opportunity to respond to the issues raised in the Preliminary Views. Following are our comments related to the issues. For some of the issues raised, we have responded that we agree with the position expressed by GASB; however we note that

there may be worthy special exceptions and that these exceptions should be carefully considered in the implementation guidelines.

1. 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.
We agree with this view.

2a. 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).
We agree with this view.

2b. The NPL is measurable with sufficient reliability to be recognized in the employer's basic financial statements.
Generally we agree with this view, but with some important qualifications. Just because a liability can be measured reliably at a point in time does not mean it is necessarily useful to the reader of the financial statements, or that it can be measured in a reliably useful way over different accounting periods.

We are concerned that the methods proposed in Issues 2 & 4 (an NPL based on the market value of assets and the rapid recognition of changes in that NPL) will lead to significant volatility in both the NPL and annual pension expense, resulting in the information not being useful. If, as will happen from time to time, significant volatility occurs, this will reduce the financial statement user's ability to determine a government's accountability for benefits and to reasonably assess interperiod equity from one year to the next.

We believe that consideration should be given to the relative quality of the accounting measurement of NPL in comparison to other accounting liability measurements on the balance sheet, such as the value of buildings, equipment and cash payables. Since the balance sheet does not display or measure the quality of the measurement shown, having the NPL on the balance sheet with other liabilities would mislead users into believing that the accounting measure of the NPL is of the same quality as the other measurements. Because the NPL is based on future predictions and its time horizon is several generations, the quality of the measurement of the NPL is well below that of other balance sheet assets. We believe that, based on accounting principles, the NPL as proposed bests fits the definition of a contingent liability and should be disclosed in the footnotes of the financial statements.

The size of the proposed NPL will likely dwarf other values on the balance sheet and give users a misleading and distorted view of the financial position of an employer. If the NPL is viewed as a liability equivalent to other entries on the balance sheet and is taken to its logical conclusion, the huge size difference

between the proposed NPL and other balance sheet assets would lead users to pay little attention to the other assets, thus reducing accountability of the employer for other activities.

We believe (as required under GASB Statement No. 27) the current recognition of a Net Pension Obligation (NPO) provides a better indication of accountability and the contribution-based Annual Pension Cost a better measurement of interperiod equity. However, if the Board believes the NPL should be recognized in the employer's financial statements, we suggest the Board consider the following additions to the recognition requirement:

i. In order to be measurable with sufficient reliability, the NPL should be determined using a smoothed (or "actuarial") value of assets rather than a market value of assets. This will at least help control the volatility of the NPL relative to other measurements on the balance sheet. It will also provide a more consistently reliable measure of liability from one period to the next.

ii. An offsetting deferred asset should be recognized on the balance sheet that is equal to the present value of anticipated future employer contributions that are committed to fund the NPL. This type of deferred asset represents accepted GAAP accounting treatment for other industries with liabilities that are expected to be funded from future earnings or payments. A good example is life insurance companies that carry a deferred commission asset representing the excess of initial commission expense on a policy over first year policy charges.

iii. The NPL should be separated into two components:

(a) the portion similar to the current NPO calculation, based on an actuarially determined contribution and

(b) the remainder of the NPL.

3a. 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 (see also question 3b),

(3) future salary increases, and

(4) future service credits.

We agree with this view.

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?

Absent action by the governing board to the contrary, we believe past action to grant ad hoc COLAs should be an indication of future actions. This approach follows the substantive plan approach of GASB Statement No. 45.

3c. 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.

We agree with the 3c(1) view and commend the GASB for the use of the long-term expected return on assets as the basic discount rate. However, when projecting assets for this calculation, we believe GASB should clarify that the assets do indeed include all "contributions from all sources related to funding the benefits of employees currently in the plan". This will often include future contributions that are to fund the unfunded liability for current members, even though those contributions are determined as a percentage of future payroll that includes future new employees. In such cases, only unfunded liability payments would be included; any contributions to fund <u>service cost</u> for those new employers would <u>not</u> be included in the projected contributions.

We disagree with the 3c(2) view. We are concerned that, while this view might have some attraction because it is consistent from one employer to the next, it might lead to unreasonable results based on the then current bond rates. We suggest use of the concept, as stated in GASB Statement No. 45, that the discount rate should be based on the estimated long-term investment yield for the source of funds expected to be used to finance benefit payments. This view results in our suggestion that 3c(2) above be changed to "the expected return on employer assets 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". Because this rate might vary from one plan sponsor to the next, some might argue that it will make it harder to compare results between plan sponsors. However, we believe this suggested alternative better represents the value of the obligation.

3d. 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.

We agree with this view, and commend the GASB for the use of a level cost of service attribution method, consistent with the pay related nature of the career-long employment exchange.

4a. The effects on the NPL 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.
We disagree with this view, especially as it applies to gains and losses (i.e. differences between expected and actual experience) and to assumption changes. Implementing this view will create significant expense volatility from one period to the next, inconsistent with the long-term nature of the employment exchange.

The nature of gains and losses is such that even the most accurate actuarial assumptions are not meant to predict what will happen from one particular year to the next. Requiring gains and losses to be recognized immediately for inactives will punish or reward current year tax (or rate) payers only to reverse results the next year or years. This produces an inequitable allocation of the ultimate cost across reporting periods and so is not consistent with the principle of interperiod equity.

The proposed treatment of assumption changes has a similar but perhaps even worse effect. A change in assumptions for inactive liabilities (e.g., earnings assumption or mortality) would cause the entire remeasurement of liability to be expensed in a single reporting period. Again this is inconsistent with the long-term employment exchange as well as violating a reasonable understanding of interperiod equity.

While we appreciate the desire to expense each member's entire liability over that member's service period, we submit that this is not an attainable goal in light of the uncertainty inherent in pension cost measurements. This requires attribution periods that are not strictly limited to the expected remaining service lives of individual employees.

We strongly suggest the Board consider amortizing (recognizing) changes over reasonable periods that takes into account the nature of the change and strikes a balance between intergenerational equity, interperiod equity and volatility mitigation. Different amortization periods could be used for gains and losses,

method and assumption changes, benefit changes, and surplus. A reasonable approach might be:

i Gains and losses are amortized (recognized) over 15 years for both active-related and inactive-related gains & losses.

ii. Method and assumption changes are amortized over 15-20 years. Assumption changes are recognition that current assumptions, if left unchanged, will result in future gains or losses. This justifies a somewhat longer amortization period than is used for gains and losses.

iii. Benefit changes are amortized over 1-15 years, depending on the nature of the change. For example it might make sense to amortize:

(1) early retirement window changes over very short periods (1-3 years);

(2) active formula changes over a longer period, such as weighted average future working lifetime, but not longer than 15 years; and

(3) retiree formula changes over 15 years but not longer than average future lifetime.

iv. Surplus is amortized over 30 years. Because surpluses can reduce contribution requirements below the normal cost and thus distort the true increase in the annual pension expense, longer amortization periods are warranted. This also reduces volatility in pension expense for any single year when temporary surpluses occurring in that year, most often created as a result of temporary investment gains, are in later years offset by investment losses. In addition, because Surplus is almost always temporary, longer amortization periods for Surplus reduces their impact on the balance sheet and presents a more accurate overall picture of the financial condition of an employer. It also reduces the probability of permanent decisions made on the basis of temporary financial conditions.

To better equalize the cost of pensions between periods, amortization should be based on a level percent of pay model. The level percent of pay model is consistent with the GASB's level cost model and best spreads the cost of final pay plans over the life of a taxpayer. As an alternative, the level dollar amortization model could be used. This model has the disadvantage of decreasing cost as a percentage of payroll, and so does not spread the cost in as an equable manner. However, this model can allow for faster expensing of pension cost.

These amortization policies meet the worthy goal of allowing readers and users of the financial statements to determine if the current path is fiscally sustainable based on a consistently reported level of expense over time. We believe the above approach strikes a much better balance over the life of a tax payer.

4b. The effects on the NPL 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.

We disagree with this view for a few reasons:

- **i. While not described as an asset smoothing method, the suggested method in fact provides "infinite" smoothing within a relatively narrow "corridor" and no smoothing outside the corridor. For example, if assets increase by five percentage points over the assumed return four years in a row, there would be no recognition of the first three years of gains and then full recognition of the five percent gain in the fourth year.**
- **ii. Economic and investment swings don't happen in one year increments. Instead we are more likely to have 2-5 years of good returns followed by 2-5 years of bad returns.**
- **iii. While future returns are expected to average out to the long-term assumed return, that does not mean we can count on future returns to mirror and so offset past experience in the short term.**

We suggest using a smoothed asset value based on established actuarial methods and standards, rather than relying solely on the corridor approach as proposed. As noted under Issue 2b and discussed further below, this smoothed asset value would be used to determine the NPL, and so would also determine the changes in NPL that are addressed here under Issue 4b.

Such a smoothed asset value would have the following attributes:

- **i. Must be market related.**
- **ii. Recognition period: Period over which annual variations of market returns from assumed returns are recognized.**
- **iii. Corridor: Range around the market asset value that the smoothed asset value must remain within.**
- **iv. Generally the shorter the recognition period, the wider the corridor can be, and the longer the recognition period, the narrower the corridor should be. In particular, if the recognition period is sufficiently short, then a corridor may not be necessary or desirable. For example a 10 year recognition period might have a 20% corridor while a five year recognition period might have no corridor or a very wide corridor.**

As for a specific recommendation, we would recommend a five year recognition period with either no corridor or a corridor as wide as 35% to 40%. While we are aware that this seems extreme, we would be happy to provide the recent experience and analysis that supports this recommendation.

Finally, there is an important relationship among Issues 2a (balance sheet reporting), 4a (amortization) and 4b (investment volatility).

i. **As discussed under Issue 2a, in order to be measurable with sufficient reliability, the NPL should be based not on market value assets but on a smoothed value. That smoothed value is described in this section, just above.**
ii. **Changes in that smoothed asset value greater or less than assumed will result in changes in the NPL "resulting from differences between expected and actual experience with regard to economic … factors affecting measurement", i.e., gains and losses in the NPL.**
iii. **Those smoothed asset value gains and losses should be amortized similar to the liability related gains and losses discussed under 4b.**

We wish to be clear that this has the effect of managing investment volatility in two ways; first by asset smoothing (as part of determining the NPL) and second by amortizing unexpected changes in the NPL that are due to changes in the smoothed asset value. This is consistent with the fact that investment return experience has far more short-term volatility than any of the demographic experience affecting plan liabilities, and so requires a separate smoothing mechanism before being amortized along with other elements of plan experience.

5a. Each employer in a cost-sharing plan is implicitly primarily responsible for (and should recognize as its NPL) 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.
We agree. (See above questions on our view on how the NPL should be calculated.)

5b. Basing the determination of proportionate shares of the collective NPO 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 basis, if any, do you suggest for determining a cost-sharing employer's proportionate share of the collective NPO?
We agree that basing the employers' NPO on the respective share of the total annual contractually required contributions is a practical method of allocating the NPO. For most cost-sharing plans, this may be the most appropriate method of determining the employers' share of the NPO. However, for some cost-sharing plans, accurate information about each employer's share of the collective NPO is available. An accurate calculation should always be used rather than an approximation when such is possible.

6. 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.

We agree with the biennial valuation requirement. However, we are very concerned the requirement that results be updated to the employer's (current) fiscal year-end will result in logistical challenges and unnecessary consulting fees. We believe this is a very difficult and complex issue. We recommend that GASB work with plan sponsors, retirement systems and the actuarial profession to develop a workable solution.

We would like to testify in person at the GASB's October 14, 2010 (San Francisco) public hearing. Again, thank you for the opportunity to comment on the Preliminary Pension Views and any consideration you give to our comments.

Sincerely,

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Chair, California Actuarial Advisory Panel

cc: Panel members:
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