

October 14, 2011

Director of Research and Technical Activities
Project No. 34-E
Governmental Accounting Standards Board
401 Merritt 7, PO Box 5116
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Dear Mr. Bean:

We are writing on behalf of many of the respective members of the National Conference on Public Employee Retirement Systems (NCPERS), the National Council on Teacher Retirement (NCTR), and the National Association of State Retirement Administrators (NASRA) to comment on the GASB's Exposure Drafts related to pension accounting and financial reporting for state and local governments.

The members of these groups together represent a critical mass of the assets and participants in the public pension community, accounting for a broad mix of trustees, administrators, and public officials who collectively manage substantially all of the nearly \$3 trillion in pension assets for approximately 21 million working and retired public employees. As decision-makers for our plans and plan sponsors, many of our members are also users of governmental plan accounting and financial reporting.

We would like to begin by complimenting the GASB's Board and staff on their diligent efforts to review the governmental accounting standards related to state and local government pensions. We understand the complexity of these issues and the difficult choices they pose. We also commend your strong commitment to open discussion and due process.

However, we are concerned that the standards presented in the GASB's Exposure Drafts will not promote GASB's key objectives of decision-usefulness and accountability. In particular, we disagree with the Board's decision to separate measures of pension accounting from pension funding on the following grounds:

1) The pension obligation does not satisfy GASB's definition of a liability for the purposes of a financial statement.

GASB Concepts Statement No. 4, paragraph 17, defines the financial statement element *liabilities* as "present obligations to sacrifice resources that the government has little or no discretion to avoid." GASB's Concepts Statement No. 3, paragraph 34, states that elements of financial statements are measurable with sufficient reliability.

The assumption that the pension obligation is essentially unavoidable is a key principle guiding the GASB's decision to treat the pension obligation as a liability and to place the net pension liability on the employer's balance sheet. However, as we have seen over the past few years, governmental employers in some states have been shifting the responsibility to pay the pension obligation to employees by raising their contributions without raising their benefits (and in some cases lowering them). For example, according to the National Conference of State Legislatures, 12 states increased contributions for current active employees in 2011. Of these, eight states increased employee contributions to partly or wholly offset employer contributions.¹ These examples provide ample illustration that many employers have discretion—significant discretion

¹ Ronald K. Snell, *Pensions and Retirement Plan Enactments in 2011 State Legislatures*, National Conference of State Legislatures, June 30, 2011.

in some cases—to shift pension funding obligations to employees.² Because these employers have this discretion, the pension obligation does not fully satisfy the Statement 4 definition of liability.

Furthermore, as discussed below, even in cases where the pension obligation may be viewed as unavoidable, it often is not measurable with sufficient reliability to be placed on the employer's balance sheet. As a result, the pension obligation often does not satisfy GASB's standard for inclusion on the financial statements.

2) The employer's annual required contribution (ARC) is a better measure of the long-term cost of pension benefits than the new pension expense (PE).

In its standard-setting process, the GASB developed a number of principles intended to guide its decisions. Two key principles are: (1) that governments are long-term entities and (2) that the employer/employee exchange is a career-long relationship. To meet these principles, the GASB's measure of pension cost should reflect the long-term cost of pension benefits for the employer. In this context, we believe the employer's ARC is a better measure of the long-term cost than the new pension expense, in that:

- The ARC reflects the best estimate of the long-term contributions to be made by the employer. By contrast, the PE is an abstract measure of the adjusted change in the net pension liability and would not be useful for determining the plan's long-term costs.
- The ARC is a more stable measure than the pension expense and better suited for budgeting purposes. By contrast, the PE will be quite volatile, especially due to the short amortization period for differences between actual and assumed investment earnings.

3) The new measures will be confusing and misleading.

The GASB's proposed changes represent a radical departure from the way pension benefits have been accounted for by state and local governments for decades. This is not to say that change is bad but the proposals would result in outcomes that substantially deviate from the stated objectives and introduce unwarranted volatility in the pension liability and pension expense financial statement representations of the plan sponsor.

Beyond that, the introduction of two sets of numbers, one to satisfy the GASB requirements, and another to inform policymakers of the amount needed to fund the plan, would lead to confusion and selective use, further impairing decision-usefulness.

Even though the new accounting numbers should not be interpreted as reflecting a decline in the funded status of public plans, it is highly likely that members of the media would present the changes in this light. In addition, there will be substantial discussion over which are the "real" numbers. The end results could be similar to what happened after GASB Statement No. 5 was released, requiring additional disclosures of the plan's funded status based on both the actuarial accrued liability (AAL) and the pension benefit obligation (PBO) determined using the projected unit credit actuarial cost method.³ This requirement created confusion about the "true" funded status of the plans. Moreover, it prompted some plans to switch to the projected unit credit

² The employer's financial reporting obligation should not be confused with the nature of the retirement benefit itself, which in some cases is an element of compensation and a constitutionally protected vested right.

³ It is worth noting that the impetus for use of a single method was the concern that to do otherwise would constitute an unacceptable departure from FASB Statement No. 35 but knowing that adoption of the FASB standard would grossly understate the going-concern accrued liability for benefits since the FASB pronouncement did not take future salary increases into consideration in the calculation of the obligation. It is also worth noting that three of the seven FASB board members who dissented to the adoption of Statement No. 35 reported that "they share an overriding concern that, taken as a whole, these provisions invite comparison of items that do not possess enough common properties to be directly comparable." We have the same concern regarding the present GASB proposal.

actuarial cost method (which generally lowered current contributions), in part to mitigate confusion. After several years, the GASB withdrew this requirement.

4) The current measures are decision-useful.

In its discussion of the reasons for the change, the GASB argues that the current measures of pension liability and expense are not as decision-useful as the new measures. However, since 2009, over 40 states have made significant changes to their pension benefits in light of poor investment performance and declining economic and fiscal conditions. These decisions were informed by the current measures, not by the GASB's new numbers. Moreover, the decisions to make the changes (and the costs of changes) were informed by actuarially determined measures. Switching to new, untested measures is unnecessary.

Furthermore, a wide array of users has become accustomed to accessing information from plan sponsors' financial reports that comply with current GASB standards. These users include state legislators and other policymakers; public employees and employers; executive officials, such as governors, mayors, treasurers, and comptrollers; members of the media; and bond rating services. Switching to GASB's new, untested measures will result in confusion on the part of the user community and could disrupt the consistency of public pension reporting. Such confusion and inconsistency will in turn reduce the accountability and decision-usefulness of public retirement system sponsors' financial reporting rather than enhance it.

5) The changes could cause state and local governments to violate statutory and constitutional provisions prohibiting deficit spending.

In comments to the GASB Exposure Drafts that have already been posted, there is at least one state where implementing the ED's provisions would likely result in violations of statutory and constitutional prohibitions against deficit spending. As discussed in the respondent's comments, the most likely response by the state legislature will be to exempt the related funds from GAAP determination for legal purposes. The author of the comments notes that this would lead to a widening gap between states' legal/budgetary reporting and financial reporting under GAAP.

Comments Related to the Net Pension Liability and Pension Expense

We hope our comments above will lead the GASB to review its decision to separate accounting measures from funding measures and return to an approach based on the ARC. However, if the GASB decides to continue with the approach presented in the Exposure Drafts, we would suggest the following changes.

1) Use a smoothed value of assets to determine the net pension liability (NPL).

We believe that use of the fair (market) value of assets to determine the NPL is not consistent with the GASB principle that governments are long-term entities. Since the market value changes daily, at times by significant amounts, the value of reporting this figure as of a given day is not decision-useful. Rather, reporting the asset value on a smoothed basis, so that the value is more consistent with trends rather than spot prices, would produce an amount that more accurately reflects the value of the plan's assets. This would also help make the measure more reliable and less volatile.

2) Use taxable municipal bond yields to determine the blended rate.

We believe that if the blended discount rate is to be used, the municipal bond rate should be based on taxable municipal bonds. If a government covers its pension obligation by issuing debt, the rate it pays will be the taxable rate.

3) Allocate changes in active members' benefits over the active members' average remaining service life.

As proposed in the GASB Exposure Drafts, a change in the pension liability due to a change in active members' benefits should be recognized immediately in an employer's pension expense. However, when employers make changes to the benefits of active employees, they do so for economic reasons. These include retaining current employees, attracting new employees, and improving employee motivation. This suggests that the employer's decisions to change benefits affect not only the current period, but future periods as well. Moreover, a key GASB principle is that the employer/employee exchange represents a career-long relationship. Consequently, we believe changes in active member benefits should be deferred and recognized in the pension expense over the active members' average remaining service life, rather than being immediately recognized in the pension expense.

4) Measure active members' average remaining service life as a simple average.

As currently presented in the Exposure Drafts, the method for calculating average remaining service life seems to suggest that the average be weighted by the active member's liabilities. We understand that, if a liability-weighted average is used, average remaining service life would likely fall below 10 years for general employees and teachers and possibly below 5 years for public safety employees. To extend this to a more reasonable period, we recommend the final statements clarify that average remaining service life can be measured as a simple average.

5) Retain the use of the Net Pension Obligation, or an alternative figure, for placement on the employer's basic financial statements.

In our response to the Preliminary Views document in 2010, we stated:

[A]lthough a pension obligation may be unavoidable, it often is not measurable with sufficient reliability; 2) the NPL will be volatile and lack reliability; and 3) the addition of the NPL to the basic financial statements may overshadow other important disclosures and incorrectly give them the appearance of being immaterial, particularly when examined in the context of the volatility and unreliability of the NPL.

...

[T]he size of [the NPL] ... is demonstrably unreliable. ... Pension benefits sponsored by many states and local governments can be altered, actuarial assumptions may change, and a plan's investment experience inevitably will vary from expectations.

We then cited examples from five states where pension benefit levels have been modified recently, resulting in material changes (reductions) in unfunded pension liabilities.

Since that letter was written, two additional developments have occurred. First, courts in two states—Colorado and Minnesota—affirmed the authority of those states to make the changes that resulted in materially lower unfunded pension liabilities. The deadline for appealing the decision in Minnesota has passed, so that legal ruling will stand. The Colorado decision is being appealed. Secondly, this year legislatures in at least three more states—Maine, New Jersey, and Oklahoma—also took actions that reduced pension benefit levels for existing plan participants, thereby reducing unfunded liabilities.

We believe that these legal and legislative developments provide additional evidence that a net pension liability lacks reliability and will introduce material volatility to basic financial statements. The result will be a lack of decision-usefulness.

Financial statement users who wish and need to know the amount of pension obligations know and understand where that information can be found under the current standards. Requiring the NPL to be incorporated into basic financial statements will cause confusion about the size and meaning of information on that schedule and diminish its decision-usefulness.

Comments Related to Cost-Sharing Employers and Plans

Generally, for employers in cost-sharing multiple employer plans, we do not agree with the GASB's decision to allocate the cost-sharing plans' net pension liability (NPL), pension expense (PE), and deferred outflows of resources and deferred inflows of resources (DO/I) to the participating employers. We believe cost-sharing plans constitute a form of insurance and that the costs should not be allocated to the individual employers.

We also believe that requiring multiple-employer cost-sharing plans to allocate their costs and liabilities among their plan sponsors would contradict the legal framework of some cost-sharing pension plans. For example, Nevada Revised Statutes 286-110 (4), pertaining to the Nevada Public Employees Retirement System, states, "The respective participating public employers are not liable for any obligation of the System." The GASB proposal to require allocation of liabilities appears to directly contradict Nevada state statutes.

We note that the Financial Accounting Standards Board recently rejected a proposal that would have required employers contributing to multiemployer defined benefit plans to disclose additional information about their participation in such plans, including the employer's potential withdrawal liability, in the notes to their financial statements. The reporting change would have required employers to report potential withdrawal liability even if an employer considered the likelihood of incurring that liability to be "remote."

The FASB received several hundred comments in response to this proposal. In its decision to reject the proposal, the FASB stated, "Respondents were largely opposed to requiring disclosure of withdrawal liability because of concerns about its appropriateness as a proxy, the cost to compute this amount, the timeliness of the information, and the potential confusion it could cause users."

For accounting purposes, we believe that the withdrawal liability of a private-sector multiemployer defined benefit plan is directly analogous to the costs and liabilities of cost-sharing plans in the public sector. The concerns about the proposal that were expressed—and ultimately affirmed by the FASB—i.e., that withdrawal liability is an inappropriate proxy for pension plan sponsors; and the potential confusion this information could cause, stand athwart GASB's objectives of decision-usefulness and accountability.

If the costs are to be allocated to employers, we believe the proposed approach is extremely complicated and would have costs that far outweigh the benefits. Consequently, we recommend steps be taken to simplify the measures, including:

1) Use the plan's fiscal year-end date.

As currently proposed in the Exposure Drafts, measures of the employer's NPL, PE, and DO/I would be based on the employer's proportionate share of the plan's collective NPL, PE, and DO/I. The calculation of the plan's NPL, PE, and DO/I would be done as of the plan's fiscal year-end date. The employer's proportionate share of the plan's NPL, PE, and DO/I would be determined as of the employer's fiscal year-end date. However, different employers in cost-sharing plans may have different fiscal year-end dates. This requires the plan's NPL, PE, and

DO/I to be adjusted to the employer's fiscal year-end dates before the proportionate share is calculated. Keeping track of this would be complicated and expensive. A simple solution would be to use the plan's fiscal year-end date to determine the employers' proportionate shares.

Note that agent multiple-employer plans and participating employers are also faced with a similar situation in that the employer's fiscal year-end dates may not (and often do not) coincide with the plan's fiscal year-end dates. In order to comply with the GASB's requirement to value the employer's liabilities and assets as of the employer's fiscal year-end date, the agent plan will need to provide each employer with the market value of the employer's assets as of the employer's fiscal year-end date. Obtaining this information (potentially on a monthly basis) could be very expensive for the agent plans, particularly for assets that are not publically traded. Again, a simple solution would be to use the plan's fiscal year-end date to determine the agent employer's net pension liability, plan assets, and pension expense.

2) Simplify calculation of the employers' proportionate shares.

With regard to calculating the cost-sharing employers' proportionate shares, the Exposure Drafts require the shares to be based on each employer's "projected contribution effort" compared with the collective contribution effort of all employers in the cost sharing plan. We recommend that this approach be clarified and simplified.

Comments Related to Transition and Effective Dates

The rules presented in the Exposure Drafts are complicated and represent a momentous and fundamental change in how pensions are measured. Many details have yet to be worked out, especially for cost-sharing multiple employer plans. In addition, state and local government decision-makers have been and remain focused on the economy and their budgets and have not had time to review the new rules. Many have lost experienced staff due to layoffs or retirement and are having trouble finding qualified replacements.

Finally, assuming that GASB proceeds to, in its words, "separate how accounting and financial reporting is determined from how pensions are funded," the results will be that amounts required to be shown on the employer's balance sheet will no longer be directly linked to the actuarially determined amounts found by the employer's plan as necessary to fund its liabilities over time. The absence of this close connection between such actuarially calculated annual pension contributions and GASB standards could invite a lack of uniformity that could be very damaging to the long-standing success of the ARC in providing (1) a target for policymakers to use in funding pension costs, and (2) a tool enabling users of financial statements to know whether or not plan sponsors are fulfilling their fiduciary obligation to properly fund the pension benefits under their purview. Given sufficient time, we are therefore hopeful that an acceptable replacement for the GASB ARC can be developed with the cooperation of the governmental plan community, and we are in the process of initiating steps to accomplish such a goal.

As a result, we strongly recommend that the effective dates be extended for at least another year (i.e., periods beginning after June 15, 2013 for large plans and employers and periods after June 15, 2014 for everyone else).

Thank you for this opportunity to comment.

Sincerely,

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Diane E. Scott, CPA	Chief Financial Officer	Retirement Systems of Alabama
William B. Lundy	Chairman	Arkansas Fire and Police Pension Review Board
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