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(The full document is available here)

We appreciate the reflection of the many commentaries submitted last summer in the GASB's Preliminary Views (PV). Our summary response to the questions stated in the PV focuses on the issue on Total Pension Liability (TPL) and the way some changes, particularly from experience and assumption changes should be addressed in a manner that creates less expense volatility than the the PV suggests. We urge the GASB to reconsider the asset valuation method used in the offset to the TPL and the methods proposed for recognition of changes in the Net Pension Liability (NPL) to reporting periods.

We acknowledge the new direction presented in the PV focusing on accounting measurement separate from funding. We urge the GASB, however, to consider that the public may be better served if measures of pension accounting cost and funding cost are more closely related. This position is based on both practical and theoretical reasons.

1. Accounting vs. Funding and Accountability. Because the current ARC-based expense is a viable basis for contributions, the annual disclosure of contributions versus the ARC provides essential information to assess the employer's accountability for the pension obligation. The loss of that expense/funding connection raises practical issues that the GASB should consider and address:

    1. The GASB should consider how the new reporting will provide decision-useful information about employer accountability if there is no connection between pension

[Needs and Risks Committee in the United States and the Pension Advisory Task Force in Canada]

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expense and the amounts actually funded.

2. The GASB should consider how financial statement users will understand and reconcile two different measures of pension cost–one for accounting and one for funding.

2. Accounting vs. Funding and Interperiod Equity. The PV addresses interperiod equity (IPE), the matching of current period inflows of resources with current period costs of services. We suggest the GASB consider the volatility of measurements when attributing pension cost over reporting periods as another aspect of IPE.

    1. The matching of current period inflows and costs in a career context addresses what is often called intergenerational equity. Period-to-period IPE should provide that the cost attributed to a period does not affect that period inequitably compared to periods just before and after.

    2. The PV treatments of certain changes in actuarial assumptions lead to an expense measure that could be extraordinarily volatile from period to period. Given the long-term nature of the pension obligation, this could produce a clearly inequitable allocation of cost from one period to the next.

    3. The GASB could address this interperiod inequity by explicitly incorporating volatility management into its recognition of changes in NPL. This will lead to a balancing of demographic measures (for intergenerational IPE) with longer recognition periods (for period-to-period IPE).

3. Accounting vs. Funding and the level cost of services model. Aside from these practical points, there is a strong theoretical basis for maintaining a relationship between funding and expense in that both are intended to produce a level cost of service. This concept, as discussed below, is also consistent with the long-term nature of the pension obligation as described in the PV.

    1. The service cost and liability measures that the GASB has proposed for plans with an expectation of sufficient future funding (Entry Age method with long term earnings discount rate) are also consistent with the model approach most frequently applied for funding purposes among public plans, because both expense and funding are intended to maintain a consistent relationship to compensation levels.

This means the level-cost method is equally appropriate for accounting cost (expense) and funding cost (contributions).

2. As a result, expense and funding start out from the same level cost of services (service cost). The GASB PV expense differs from funding in how it recognizes variations around that level cost, variations caused by investment return and by changes in the TPL through benefit changes, experience gains/losses, and assumption changes.

3. We recognize that there may be reasons to recognize such variations differently for expensing vs. funding. The need to balance demographically based cost attribution with volatility management (alluded to in 2 above), however, applies equally to expensing and funding. This means that any differences should be limited.

4. Addressing these issues will greatly facilitate reconciling and understanding any difference between expensing and funding. It also could allow employers to consider funding at the same level as expensing.

With these principles in mind, here are our responses to the issues and question from the PV:

(Editor's note: The responses below may be moderately or heavily edited for brevity. Refer to the full document for further clarification.)

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. (See Chapter 2, paragraphs 5–10.)

We agree with this finding for the reasons ably presented in the PV.

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). (See Chapter 3, paragraphs 1–8.)

We agree with the finding that the NPL–whether based on market value of assets or some smoothed market-related value–meets the Concepts 4 definition of a liability, as described in the PV.

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. (See Chapter 3, paragraphs 9–13.)

We agree that an NPL based on the market value is an important measure of liability that should be disclosed in the notes to the financial statements. We believe that the NPL based on the market value of assets (which for this item only we will call MNPL), however, is not a sufficient reliability measurement for recognition on the basic financial statements (BFS). We recommend that if any form of the NPL is reported on the basic financial statements, it should be based on a smoothed, market-related value, so as to obtain a reliable measurement from period to period.

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 (see also question 3b), (3) future salary increases, and (4) future service credits. (See Chapter 4, paragraphs 4–13.)

We agree with the GASB's endorsement of a total pension liability component based on projected salaries and service, which is consistent with the GASB's conclusion that pension expense should reflect the employee's ongoing, career-long employment relationship with the employer. We also agree with the inclusion of automatic COLAs and ad hoc COLAS that are not substantively different from automatic COLAs.

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 recommend that determination of "not substantively different from automatic" should reflect the basis, process, and authority for granting such benefits, including any recent changes in such factors. Past frequency and consistency of ad hoc COLAs also should be considered. We note that this could lead to valuing the ad hoc COLA using a stated assumption as to frequency (e.g., three out of five years).

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. (See Chapter 4, paragraphs 14–23.)

We agree with the GASB's endorsement of a total pension liability and service cost measure based in large part on a long-term earnings discount rate, which is consistent with the GASB's conclusion that the "employer's projected sacrifice of resources can be effectively modified (reduced) by the expected return on investments" for accounting purposes.

When projecting assets for comparing to projected benefits values, the GASB should clarify that any anticipated contributions that are to fund benefits for current members should be included, regardless of the basis used for those contributions. We recommend the GASB clarify that the projected assets include all projected future contributions that are to fund the unfunded liability for current members.

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. (See Chapter 5, paragraphs 8–10.)

We recommend that plan changes be distinguished from gains/losses, as well as assumption changes, as fundamentally different events requiring distinct treatment when attributing their effect to reporting periods.

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. (See Chapter 5, paragraphs 12–15.)

This approach–essentially unlimited smoothing within a relatively narrow market value corridor–may be an overly simple method that will result in potentially significant volatility when determining pension cost, whether for accounting or funding. We recommend that changes in the smoothed market-related assets be amortized over a 15-year period, similar to differences between actual and expected liability experience.

This allows for effective management of investment volatility, both directly through asset smoothing and indirectly through amortization of changes in NPL due to changes in the smoothed asset value.

This also has the reporting advantage of avoiding two different deferred inflow/outflow accounts on the BFS–one for investment return and one for TPL changes–because the investment deferrals would be incorporated into the NPL.

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. (See Chapter 6.)

We do not disagree with the value and need for determination of proportionate shares of obligations among employers. There may be a need, however, to distinguish different methods for relatively large systems versus the aggregation of small systems. Within the public plan arena, there are some systems that are very dependent on the value of risk-pooling of relatively small municipal employers. Implementation of proportionate shares could become a material expense and undermine the risk-pooling benefits for these systems.

There are many anomalies that arise in the process of an artificial allocation. The resulting allocations no longer may be sufficiently reliable to fairly represent that employer's own obligation. If the employer's obligation is defined in terms of the funding requirement, then the GASB should be more consistent in the application of that principle.

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. (See Chapter 7.)

We have no major concern with this concept. While similar to the requirements of Statement 27, the requirement to consider and possibly reflect changes since the last valuation will increase allocation of entity resources to pay for these additional actuarial fees. It also is subject to fairly broad interpretation as to what must be reflected in an update and what reasonably can be deferred to the next valuation. In the agent and cost-sharing plan arrangements, this could require significant additional work, especially in situations in which different employers have different fiscal year-end dates.

Prepared by Kenneth Kent, James Rizzo and Paul Angelo. We wish to thank the members of the Public Plans Subcommittee for their collaboration during the preparation of the Academy's response to the GASB.

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