August 12, 2009

Mr. David R. Bean
Director of Research and Technical Activities, Project No. 31
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Bean:

The American Institute of Certified Public Accountants (AICPA) has reviewed the Governmental Accounting Standards Board (GASB) Invitation to Comment (ITC), *Pension Accounting and Financial Reporting,* and is pleased to offer its comments. As noted in our responses to other GASB due process documents, we have previously recommended that the GASB reexamine its current pension accounting and reporting standards. Therefore, we fully support the Board's efforts in undertaking this project. We have also previously recommended that the Board consider requiring the accrual of the entire unfunded accrued benefit obligation in the financial statements for pension benefits. As further detailed in the next section of this letter, we continue to believe that requiring this will provide more decision-useful information and improve accountability and transparency. It will also provide a better measurement of interperiod equity. The following section of this letter includes our responses to the specific issues raised in the ITC.

We also support the Board's stated intent in paragraph 3 of the ITC to consider the applicability of the tentative decisions reached regarding pensions to other postemployment benefits at a later stage in the project. We believe a common approach and similar standards for all postemployment benefits, to the extent applicable and appropriate, should be an ultimate goal of the project.

RESPONSE TO ISSUES

Question 1: To best achieve the financial reporting objectives of accountability and decision usefulness, including the assessment of interperiod equity, which of the following processes related to pensions do you believe governmental accounting and financial reporting should provide information about, and why?

a) *The process by which an employer incurs an obligation to employees for defined pension benefits earned by them*
b) *The process by which an employer finances its projected future cash outflows for defined pension benefits*
c) *Both processes.*

We believe that both processes should be considered for accounting and financial reporting purposes. The process by which an employer incurs an obligation to employees for defined pension benefits should be the basis for determining the employer's liability and, as noted in our response to Issue 2, this liability should be presented on the face of the financial statements in that it meets the definition of a liability. The obligation of a government occurs when the pension

benefits are earned by employees as services are provided, thus making the government accountable for those benefits. Focusing on this employment exchange provides more decision useful information to users of governmental financial statements (e.g., citizenry, legislative and oversight bodies, and investors and creditors) regarding the true cost of employee compensation since pension benefits are a promise to employees and are part of the total cost of providing governmental services to constituents. It also provides the information needed to assess interperiod equity. While we understand this method may cause more period-to-period volatility, the benefits to users (e.g., accountability, transparency, decision usefulness, and interperiod equity considerations) outweigh the period-to-period volatility.

In our view, basing the liability on the funding process (i.e., recording a net pension obligation based on payment of the annual required contribution) does not properly measure the true obligation of a government. With that said, the process by which an employer finances its projected future cash outflows for defined pension benefits does provide decision useful information about how the long-term liability described above will be financed over time. We believe that such information would be more appropriately disclosed as a note to the financial statements based on the guidance provided in GASB Concepts Statement No. 3, *Communication Methods in General Purpose External Financial Reports that Contain Basic Financial Statements*, paragraphs 35 – 38. Information regarding how a government is funding the projected future cash outflows is essential to a user's understanding of governmental financial statements.

Question 2: What obligations of a sole or agent employer associated with pensions meet the definition of a liability in Concepts Statement No. 4, Elements of Financial Statements, *and why?*

a. *A measure of the cumulative difference between (1) amounts expensed, based on annual required contributions of the employer to the pension plan pursuant to a program of funding pension benefits developed within established parameters, and (2) the amounts the employer actually has contributed to the plan*
b. *A measure of the employer's unfunded accrued benefit obligation to employees at the financial report date related to the employment agreement governing the exchange of employee services for salaries and benefits*
c. *Other. (Please identify the obligation that you believe best meets the liability definition.)*

As noted previously, we strongly believe that the measure of the employer's unfunded accrued benefit obligation meets the definition of a liability in Concepts Statement No. 4 *Elements of Financial Statements* (i.e., response (b)). Paragraph 22 of Concepts Statement No. 4 states that, "for an obligation to be a liability, it should be a present obligation." Further, paragraph 17 of Concepts Statement No. 4 states that, "Liabilities are present obligations to sacrifice resources that the government has little or no discretion to avoid." The obligation attached to a pension benefit is incurred with the exchange of employee services and creates a present obligation. Once the present obligation has been created based on service, governments have little or no discretion to not pay the benefits that were earned by employees. Therefore, the employer's unfunded accrued benefit obligation is a liability. Further, we see no reason that this liability should be treated any differently than other currently required payroll related liabilities (e.g., compensated absences).

We recognize that the unfunded accrued benefit obligation is currently required by GASB Statement No. 50, *Pension Disclosures,* to be disclosed in the notes to the financial statements and in required supplementary information. However, because we believe that the unfunded accrued benefit obligation meets the definition of a liability, we believe it should be reported on the face of the financial statements to measure the annual cost of pension benefits earned and the demands on future cash flows. As noted in our response to Issue 1, information related to the financing of the obligation including the funding method and the relationship to the annual required contribution should be included in the notes to the financial statements.

Some have argued that that the unfunded accrued benefit obligation should not be reported as a liability because it is not estimable. The Board itself stated in the basis for conclusions for GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* that the nature of actuarially determined information is inconsistent with the precision and reliability required of the financial statements. We disagree with this conclusion. While actuarially determined information is based on estimates using many assumptions, actuarial science is well established and there are numerous instances in which financial statements are affected by actuarial calculations and are reliably stated (e.g., self insurance liabilities, pension liabilities in the private sector). We believe that the application of actuarial valuations to pension benefits would produce reasonable information for purposes of financial reporting.

Others have argued that a reason not to record the unfunded accrued benefit obligation is because the pension environment for governments differs from the private-sector environment. The Board supported this notion in the basis for conclusions for GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, where it stated that it would be confusing and potentially misleading for legislators, public officials, and others who make decisions about benefit levels and contribution rates to provide accounting measures of pension information that differ from those produced by the funding method. We disagree. By not recording the full pension liability as employees provide services, the costs shift to future generations. We believe that the unfunded accrued benefit obligation should be reflected as a liability so that those who make decisions about benefit levels truly understand the full impact and costs associated with their decisions. Further, those decisions would also be transparent to the public and other users of governmental financial statements. While there may be some differences between the governmental pension environment and the private-sector environment, we believe that none of those differences would justify basing the liability on the financing of the pension obligation.

Question 3: Which of the following expense recognition patterns is more consistent with the concept, in paragraph 27 of Concepts Statement 4, that applicability to a reporting period or periods for purposes of expense recognition in government-wide, proprietary fund, and fiduciary fund financial statements should be determined based on the notion of interperiod equity, and why?

a. *Recognition of the effects of transactions and other events that affect the unfunded accrued benefit obligation as they occur each year*

b. *Deferred recognition (deferral and amortization) of some or all components of pension cost other than normal cost over a number of future years determined by an employer or by plan trustees within accounting parameters.*

We propose an alternative that would report the effects of transactions and other events that do not result from direct management action (e.g., actuarial gains and losses) in a separate line item below general revenues on the statement of activities and below non-operating expense in the proprietary funds statement of revenues expenses and changes in fund net assets. The gains or losses from these types of transactions and events would be amortized over time to operating expense (see our response to question 6 below for our specific feedback on amortization). However, we recommend that the effect of transactions and other events that result from a direct management action (e.g., a management decision to revise a plan resulting in a change to the amounts of projected pension benefits), should be recognized as expense as they occur in the government-wide statement of activities and as operating expense in the proprietary fund statement of revenues expenses and changes in fund net assets. Further, any retroactive changes to benefits for services already provided should be required to be recognized concurrent with the change in benefits in order to better address interperiod equity.

Question 4: Should the projection of pension benefits include or exclude the following projected future changes? Why?

a. *Automatic cost-of-living adjustments (COLAs)*

Automatic COLAs should be included in the projection of pension benefits as such adjustments are embedded in the terms of the pension plan and would have been contemplated by employees as part of their exchanged services.

b. *Projected future ad hoc COLAs, in circumstances in which ad hoc COLAs are substantively a part of the employment agreement, as demonstrated by an employer's pattern of practice*

Projected future ad hoc COLAs should typically be included in the projection of pension benefits when an employer's pattern of practice has made ad hoc COLAs substantively a part of the plan terms. This would be consistent with the "substantive plan" concept as defined in Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* and Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. Those standards include a responsibility to consider whether the benefit terms expressed in the written plan document differ from the terms as communicated to plan members, understood by the employer, and plan members to be part of the employment exchange, and actually applied and demonstrated through a pattern of practice. This concept could be applied as it relates to projected future ad hoc COLAs.

c. *Projected future salary increases*

Projected future salary increases should be included in the projection of pension benefits if it is reasonable to conclude that there is an implied contract that such increases will occur. We believe

that for many governments it is reasonable to conclude that there is an implied contract that future salary increases will occur and thus it would be appropriate to include future increases in the calculation of the obligation.

d. Projected future service credits.

Projected future service credits should be included in the projection of pension benefits to alleviate back-ending of expense in plans that have an uneven formula (e.g., 1% of final pay for each of the first 15 years and 2% of final pay for years in excess of 15 years) and properly attribute the cost of the benefits to the period earned.

Question 5: What should be the basis for determining the discount rate used for discounting projected pension benefits to their present value for accounting purposes? Why?

a. The estimated long-term investment yield for the plan
b. A risk-free rate (or a yield curve of risk-free rates applied to cash flows of different maturities)
c. The employer's borrowing rate
d. An average return on high-quality municipal bonds
e. Other.

We support the estimated long-term investment yield as the basis for determining the discount rate since the present value of projected benefits is integrally related to the way in which plan net assets are invested. While we support the long-term investment yield for the plan, we suggest that the Board further consider developing guidance on the use of an appropriate yield that would take the funding level of the plan into account. Allowing the full benefit of the investment returns in situations where a plan has been chronically and significantly underfunded is not appropriate. We recommend the Board further consider guidance for appropriate yields as this issue is deliberated going forward.

Question 6: If, after due process, the accounting measurement approach adopted by the Board for pensions were to be one of those discussed in Chapter 4 that includes the amortization of some components of pension cost for purposes of recognition of an employer's pension expense:

a. Which actuarial cost method or methods should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?

As noted our comments on previous GASB due process documents, we recommend that the Board require a single actuarial cost method for determining an employer's pension obligation and expense. The use of one method will promote consistency in the valuation of the liability. Allowing multiple methods significantly diminishes the ability to make informed comparisons among governmental employers with regard to the financial effects of their defined benefit commitments. Further, limiting the methods to one would improve the decision usefulness of financial reporting.

We believe that of the six methods currently available, the projected unit credit (PUC) method is more explicitly intended to measure the accrual of pension benefits. While we understand that

GASB research has shown that the majority of pension plans are currently using the entry age method, we believe that the PUC method is most appropriate. As noted in the ITC: 1) it is more explicitly intended to measure the accrual of pension benefits; and 2) its use would attribute pension cost to periods in a way that would be more nearly representative of the way in which plan members accrue benefits in most pension plans.

> b. *What should be the maximum amortization period or periods permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?*

We believe that the current parameter allowing a maximum of 30 years is too long of a period for deferred amounts. We consulted with several actuaries with governmental pension experience and the recommendation was a maximum period of between 10 and 15 years. We believe that this shorter period will still allow for smoothing of short-term fluctuations. GASB should confer with actuarial experts to further determine the most appropriate period within the 10 – 15 year range. We did discuss with the actuaries the pros and cons of linking the amortization period to remaining service life. However, their observation that a significant number of participants in many governmental plans are retired with no remaining service life led us to conclude that using remaining service life may not be appropriate.

> c. *Should different maximum amortization periods be set for different types of changes to the unfunded accrued benefit obligation? Why or why not?*

We support one amortization period, but would like to recommend that retroactive changes to benefits for services already provided be required to be recognized concurrent with the change in benefits.

> d. *If you answered yes to question 6c, what should be the maximum amortization period for benefit changes applied retroactively to past periods of service that were not substantively part of the employment agreements that established the compensation for services in those periods or were not previously included in the projection of pension benefits? What should be the maximum amortization period for actuarial gains and losses? Why?*

Not applicable as we support one amortization period.

> e. *Which amortization method or methods should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?*

We support a closed period amortization method as the single amortization basis. This method defines the amortization period from one date and declines to zero with the passage of time which results in more easily understood amortization of pension costs to the financial reporting periods.

> f. *What method or methods of determining the actuarial value of plan assets should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense? Why?*

The actuarial value of plan assets should be based on fair value when determining the unfunded accrued benefit obligation and disclosing the funded status of the plan. The use of fair value is consistent with recognizing changes in the accrued benefit obligation as the underlying

transactions and events occur. In addition, the fair value is consistent with the reporting of the plan assets in the plan's financial statements, which are readily available and are often included in the government's reporting entity. The use of fair value represents assets currently available to fund benefits, which is readily understood by users of the financial statements.

Question 7: Does the relationship between a cost-sharing employer and the cost-sharing multiple-employer plan in which it participates differ enough in economic substance from the relationship that a sole or agent employer has with the plan in which it participates to support different requirements with regard to liability and expense recognition? Which of the following views best represents your view, and why?

a. *The relationship does differ in economic substance, and current measurement, recognition, and disclosure requirements appropriately account for the pension cost and obligation of an employer in a cost-sharing plan.*
b. *The relationship does differ in economic substance, and current measurement and recognition requirements are appropriate; however, additional disclosures by cost-sharing employers are needed.*
c. *The relationship does not differ in economic substance; a cost-sharing employer has a long-term pension obligation based on the employment exchange and should measure and recognize its obligation and expense in a manner similar to that for sole and agent employers.*

Response (c) most appropriately represents our views in that we believe there is not a sufficient difference in economic substance between the relationship of cost-sharing employers with their pension plans and sole and agent employers with their pension plans to support a difference in liability and expense recognition. However, in deliberating our response to this question, we struggled to identify a recommendation to the Board in terms of a reasonable method for allocating the liability to the various employers. One option discussed was to perform the allocation based upon expected future payments into the plan for current employees. With that said, we continue to believe that the Board should pursue this in its future deliberations and recommend that the Board consult with actuarial experts to determine the most appropriate allocation method.

If, after due process, the Board does not accept our recommendation and current practice of reporting pension costs and obligations for cost-sharing plans is maintained, we highly encourage the Board to address the application of the cost-sharing method by being more prescriptive on the prerequisites for qualifying as a cost-sharing plan for accounting and financial reporting purposes. For example, in instances where a single employer makes up the vast majority of the plan (e.g., 90% or more), it does not seem reasonable to limit the recognition of pension costs to required contributions and not recognize the employer's unfunded accrued benefit obligation. We would also encourage the Board to enhance the current disclosure requirements for cost-sharing employers to include, for example, more explicit explanations of the nature of the cost-sharing plan, in the notes to the financial statements.

Question 8: Which of the following should a pension plan report as its liability in regard to pension benefits, and why?

a. *A liability for benefits currently due and payable*
b. *The accrued benefit obligation, however measured.*

Pension plans should report a liability for benefits currently due and payable as this approach most closely fits the definition of liabilities in Concepts Statement 4. Neither the plan trustees nor administrators would be responsible for the payment of accrued benefit obligations in excess of the plan's assets in a plan that was less than fully funded; that is the obligation of the employer.

As noted in the ITC, the accrued benefit obligation establishes a funding target for assessing funding progress which may be useful to place plan net assets in context. However, we believe it would only be an appropriate note disclosure to the financial statements.

Question 9: Should a presentation of changes in the unfunded accrued benefit obligation be a required part of general purpose financial reporting? Why or why not?

a. *If yes, which financial report(s) should contain that presentation: the employer's, the plan's, or both? Why?*
b. *If yes, should the presentation be a basic financial statement, a note to the basic financial statements, or required supplementary information? Why?*

We support the presentation of changes in the unfunded accrued benefit obligation in the notes to the basic financial statements for both the employer and the plan as we believe this information is essential to a user's understanding of governmental financial statements.

Presenting changes in the financial statements of both the employer and the plan raises an issue of timing of the valuation of the unfunded accrued benefit obligation. For single-employer plans, the valuation of the accrued benefit obligation should be performed as of the reporting date for the employer and the plan. If the plan's year-end differs from the reporting date for the single reporting unit, this would require two valuations. For multiple-employer plans where employers' fiscal years do not align with the plan year end, we recognize that having multiple valuations performed would be a significant burden. Therefore, we would propose allowing multi-employer plans with differing fiscal years to use the valuation of the unfunded accrued benefit obligation as of the plan's year-end as long as the valuation has been performed during the employer's fiscal year.

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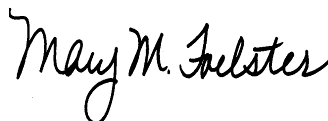
The AICPA appreciates the opportunity to comment on the ITC. This comment letter was prepared by members of the AICPA's State and Local Government Expert Panel and was reviewed by representatives of the Accounting Standards Executive Committee (AcSEC) who did not object to its issuance. Representatives of the AICPA would be pleased to discuss these comments with you at your convenience.

Sincerely,



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