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October 4, 2010

Mr. David R. Bean
Director of Research and Technical Activities
Project No. 34p
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) Preliminary Views (PV), *Pension Accounting and Financial Reporting by Employers,* and is pleased to offer its comments. As we stated in our response dated August 12, 2009, to the related March 2009 Invitation to Comment (ITC) titled, *Pension Accounting and Financial Reporting,* we fully support the GASB's efforts to reexamine its current pension accounting and financial reporting standards. The PV takes an important step in the reexamination process and we are very pleased that many of the comments that we recommended to the Board in our letter on the ITC were adopted as part of the Board's preliminary views. However, there are certain aspects of the PV where we differ with the Board's preliminary conclusions that are summarized in the following section of this letter.

RESPONSE TO QUESTIONS FOR RESPONDENTS

Issue 1—An Employer's Obligation to Its Employees for Defined Pension Benefits

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.) Do you agree with this view? Why or why not?

We agree with the Board's view that an employer remains primarily responsible for the portion of its benefit obligation to employees in excess of the plan net assets available for pension benefits. We also agree with the Board that, to the extent that plan net assets have been accumulated, the employer becomes secondarily responsible, and the pension plan is primarily responsible, for the obligation.

As further detailed in our letter on the ITC, our views on this question are based on our strong belief that the government employer has an obligation to employees to provide pension benefits resulting from the exchange transaction that occurs as employees provide

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services (i.e., the employment exchange). The payments made by the employer to a pension plan only transfer obligations to the pension plan to the extent that dedicated assets exist. However, it is the government that remains primarily responsible for the unfunded obligation.

Issue 2—Liability Recognition by a Sole or Agent Employer

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.) Do you agree with this view? Why or why not?

Similar to our response on the ITC 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*, we strongly agree with 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. 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 employment exchange 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, similar to other payroll liabilities, the unfunded portion of the employer's obligation is a liability.

Additionally, not recording the employer's net pension liability as employees provide services shifts those costs to future generations. Therefore, we believe that the employer's net pension liability 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.

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.) Do you agree with this view? Why or why not?

We agree with 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. As paragraph 11 of chapter 3 of the PV points out, uncertainties with regard to amounts expected to be received or paid in the future are already incorporated into the measurement of elements of basic financial statements in other contexts. Further, as stated in our previous comment letter, actuarial science is well established and there are numerous instances today in which financial statements are affected by actuarial calculations and are reliably stated (e.g., self-insurance liabilities and pension liabilities in the private sector). We believe that the application of actuarial valuations to pension benefits would produce sufficiently reliable information for purposes of financial reporting.

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

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.) Do you agree with this view? Why or why not?

We agree with the Board's preliminary view that the projection of pension benefit payments should include the projected effects of automatic COLAs, certain future ad hoc COLAs, future salary increases, and future service credits. We believe that automatic COLAs should be included as such adjustments are embedded in the terms of the pension plan and are contemplated by employees as part of their exchanged services. Future ad hoc COLAs should also be included when an employer's pattern of practice has made ad hoc COLAs substantively part of the plan terms. This approach is 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*. 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. Future service credits should also be included in the projection of pension benefits to alleviate the 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.

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?

As stated in our previous comment letter, we believe it is the employer's pattern of practice that makes ad hoc COLAs substantively part of the plan terms. In considering the question posed in the PV, we believe that the intent of the government should be considered in evaluating whether an ad hoc COLA is substantively different from an automatic COLA. We believe that if a pattern of practice is established, the assumption would be to include the ad hoc COLA in the projection of pension benefit payments for accounting and financial reporting purposes. We suggest that the Board consider guidance similar to that included in GASB Statements No. 43 and No. 45, which provide guidance on evaluating what constitutes a substantive plan as we believe that the concept might also be relevant for ad hoc COLAs.

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.) Do you agree with this view? Why or why not?

In discussing the Board's preliminary view related to the discount rate to be used to calculate the present value of total projected benefit payments we had a number of concerns and questions with the proposal. In our previous letter, we requested the Board consider developing guidance on the use of an appropriate yield that would take the funding level of the plan into account and we appreciate the Board's attention to this issue in this PV. However, we have concerns about the current proposal because it raises interpretative issues which will likely result in disparity in application. For example, the projected point of depletion of plan assets is a key determination in the PV and we are unclear how it would be determined. Additionally, we are concerned with the inclusion of projected amounts of future contributions which we believe will be misleading in that there is no certainty surrounding whether those projected contributions will actually be made.

The PV calls for one discount rate reflecting the expected long-term 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 a second discount rate to be applied beyond the point at which plan net assets available for pension benefits are projected to be fully depleted. However, in light of our concerns on the proposed PV approach and our view that they will be difficult to overcome, we recommend that the Board consider an alternative approach for determining how to bifurcate the discount rate in accordance with the position set forth in the PV. One approach which we believe is conceptually straightforward could be referred to as the "run off" approach. Under this approach, a projection of cash flows would be performed to include projected asset growth based on the long-term rate of return and benefit payouts. Future contributions would not be part of this projection nor would earned credits. Based on this projection, benefit payments would be supported by current plan net assets until the projected assets are zero. The present value of these benefit payments would equal the plan's current net assets. From that point in time until the final benefit payment is made, all payments would be discounted at the "unfunded rate" (discussed in the next paragraph). This would produce a present value for the unfunded portion. The funded present value plus the unfunded present value would equal the total present value of the benefit obligation. These two amounts could be presented separately as present values based on the respective rates. Alternatively, they could be presented as a single present value with a blended rate. The blended rate would be obtained by finding a single rate that would

discount all future cash flows to a present value equal to the total present value of the two portions described above.

The PV states the Board believes that the discount rate for projected benefit payments for which plan net assets are not projected to be available should be based on an index rate for governmental bonds of a high quality commensurate with the quality of the pension liability. Instead, due to our concerns with the PV approach, we believe that the Board should consider other alternatives. For example, the present value related to the "unfunded" portion could be based on the long-term expected yield on the employer assets that are expected to be used to pay benefits as they come due (i.e., long-term return on operating funds). This method reflects a funding approach. Another alternative would be to apply a settlement rate to the "unfunded" portion. Given that a settlement rate is a market rate and not entity specific it would provide consistency in application and reflects what a government would pay to settle the obligation related to the "unfunded" portion.

Ultimately, in order to achieve comparability, the Board should revise its proposal in this area to develop an understandable, concise method to apply the discount rate. While we acknowledge that the Board prefers a more principles based approach, we believe that being more prescriptive in this particular area will facilitate communication between actuaries, auditors, and governments trying to implement this guidance and will promote consistency in application.

If the Board maintains its current view we ask that clarification be provided on how the point at which plan net assets available for pension benefits are projected to be fully depleted would be determined. We believe such a calculation would necessitate using an actuary, but this is not clear in the PV. Further, we also ask the Board to consider eliminating the inclusion of projected amounts of future contributions in the calculation of projected benefit payments for which plan net assets are projected to be available due to the uncertainty surrounding whether such projected contributions will be made. In short, more guidance on determining what constitutes the two streams to apply the two different rates to and more guidance on applying the rates and results are needed if there is to be consistency in financial reporting.

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. (See Chapter 4, paragraphs 24–34, and Chapter 5, paragraphs 6 and 7.) Do you agree with this view? Why or why not?

We agree with Board's preliminary conclusion to only permit a single method for determining an employer's pension obligation and expense. Permitting only one method will promote consistency in the valuation of the liability and improve the decision usefulness of financial reporting. Alternatively, allowing multiple methods significantly

diminishes the ability for financial statement users to make informed comparisons among governmental employers with regard to the financial effects of their defined benefit pension plan commitments.

However, we disagree with the Board's preliminary selection of the entry age actuarial cost method applied on a level-percentage-of-payroll basis as the permitted method. Instead, we continue to recommend that the Board select the projected unit credit (PUC) method as the permitted method. We again discussed the PUC and entry age methods with actuaries as we deliberated the PV. Based on our understanding from the actuaries that we consulted with, PUC is more explicitly intended to measure the accrual of pension benefits and 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. PUC reflects how benefits are earned and how they get established and grow and, therefore, provides a better measure of the current obligation based on the benefit formula and how benefits accrue under the plan.

It is also our understanding from our discussions with the actuaries that, in general, entry age has more of a funding perspective and attributes the cost based on a level-percentage-of-payroll regardless of how benefits are earned which results in a smoother expense pattern.

Even though GASB research has shown that the majority of pension plans are currently using the entry age method, we continue to believe that PUC is more appropriate because it better reflects the liability related to the pension obligation at a particular point in time. Further, as discussed in paragraph 27 of chapter 4 of the PV, the incremental cost of having an actuary apply two cost methods for different purposes (i.e., funding versus accounting and financial reporting) would be relatively small. Therefore, in our view the benefit of applying PUC would be worth the incremental costs to those governments currently applying the entry age actuarial method.

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

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.) Do you agree with this view? Why or why not?

We disagree with the Board's view that the effects of changes in the total pension liability be recognized as components of pension expense over periods representative of the expected remaining service lives, if any, of individual employees. Instead, we believe the

accounting treatment should be based on whether management had control over the change causing the effect. As discussed in our previous letter, we continue to recommend 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. We believe the amortization period should be a 10-15 year closed period for each year's gains or losses (i.e., a method that defines the amortization period from one date and declines to zero with the passage of time).

With regard to 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), we recommend that they 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 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.

If the Board continues with its preliminary view on this topic, we would support the immediate recognition of the aggregate effect on the liabilities for inactive employees. However, we recommend the Board clarify whether retirees would be considered inactive. Further, we suggest that the amortization period for the liabilities of active employees be a closed period, as described above.

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.) Do you agree with this view? Why or why not?

We disagree with the Board's proposed treatment of the effects on the net pension liability of projected earnings on plan investments including recording earnings on plan investments below or above the projected earnings as deferred outflows (inflows). Instead, we believe our proposed approach described in our response to 4(a) above, is more fundamentally sound than the Board's proposed accounting treatment that that would establish a 15 percent "corridor approach." In our view, such a corridor approach links the accounting treatment of investment returns on an arbitrary factor. Finally, we are

also unclear about the Board's rationale for the distinction between the treatment of actuarial gains and losses and investment earnings.

As noted above, we believe that the accounting treatment of the effects of changes in the net pension liability, including investment returns, should be based on whether management had control over the change causing the effect. Earnings on plan investments may or may not be related to a direct management action. To the extent a change in the net pension liability is not the result of a direct management action, our proposal would result 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 would be amortized over time to operating expense for a 10-15 year closed period. Alternatively, if a direct management action caused the change, our proposal would recognize the expenses 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 net assets.

Issue 5—Recognition by a Cost-Sharing Employer

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.) Do you agree with this view? Why or why not?

We agree with the Board's view that each employer in a cost-sharing plan should recognize it proportionate share of the collective unfunded pension obligation. As we stated in our previous letter, 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.

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. (See Chapter 6, paragraph 8.) What basis, if any, do you suggest for determining a cost-sharing employer's proportionate share of the collective net pension obligation?

In discussing the various methods that could be used to allocate the collective net pension obligation, we came to the conclusion that the best basis is that which the Board is considering—that is, basing the allocation on the total annual contractually required contributions. We believe this to be the most appropriate option since required contributions factor in both current employees and retirees.

We also discussed two other methods that could be used—separate valuations and a covered payroll approach. However, we ultimately concluded for the reasons cited below

that basing the allocation on the total annual contractually required contributions is most appropriate.

We concluded that the most precise method would be performing a separate valuation for each contributing employer and recording a liability based on each employer's demographic. However, we did not select it to recommend to the Board in light of the fact that this method would necessitate an actuary and would be both timely and costly. We believe that such a level precision is not necessary.

The other option we discussed was a method that would be based on the percentage of pay of active employees (covered payroll). However, we discarded this as a potential option due to the disadvantage this method would present in situations where one particular employer has a very small current employee base and a large number of retirees. In this situation, the other employers would receive unfair disproportionate allocation.

Issue 6—Frequency and Timing of Measurements

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.) Do you agree with this view? Why or why not?

We disagree with the Board's preliminary view that actuarial valuations be made at least biennially, as of a date not more than 24 months prior to an employer's fiscal year-end. We believe that the frequency of measurements should be annually and the timing of measurements should be dependent upon the type of plan (i.e., single-employer or multiple-employer). Consistent with our previous letter, the valuation for single-employer plans 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. We continue to believe that multiple-employer plans with differing fiscal years should use the valuation as of the plan's year-end as long as the valuation has been performed during the employer's fiscal year.

We believe the benefit of having current actuarial valuations performed and reported outweighs the cost and other practical concerns related to pension measurement. The transition to more frequent measurements may be problematic for some entities, but we believe that requiring more frequent and timely measurements will improve reporting. For many governments, the pension liability has the potential to be the largest liability reported, and thus should be measured annually.

Objective of Updates Should Be Made Clear. Paragraph 2 of chapter 7 of the PV states that "If a comprehensive measurement of the total pension liability is not made as of the employer's fiscal year-end, the most recent comprehensive measurement should be updated to that date." We were unclear as to the Board's objective regarding the updates to the comprehensive measurement of the total pension liability. For example, is it the Board's intent 1) to have current actuarially determined information as of the fiscal year-end; 2) to allow a full valuation as of an earlier date with roll forward procedures applied to bring the information current to the fiscal year-end; or 3) to use information as of a year earlier valuation without update? We recommend the Board clarify its objective.

Reporting Differences Resulting from Update Procedures. We were confused about the differences between expected and actual results from an update compared to the most recent comprehensive measurement date. In reading the PV, it appears that such differences would not be reported, but we were not entirely certain. Thus, if the Board maintains its position on updates, we ask for clarification on whether and how to report differences. Further, if a significant difference arises as a result of update procedures, we were unclear whether a comprehensive measurement would then be required or if the government could defer until the following year.

Significant Changes. In discussing the application of update procedures in lieu of comprehensive measurement, paragraph 7 of chapter 7 of the PV states that an update would not be suitable if it would not reflect the effects of all significant changes since the date of the prior comprehensive measurement. We believe that this guidance may create a great deal of disparity in practice as the evaluation of significance is dependent on preparer and auditor judgment. If the Board continues with this approach, we believe the guidance regarding significant changes should be expanded to promote consistency in application.

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The AICPA appreciates the opportunity to comment on the PV. This comment letter was prepared by members of the AICPA's State and Local Government Expert Panel and was reviewed by representatives of the Financial Reporting Executive Committee 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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AICPA State and Local Government Expert Panel

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cc: State and Local Government Expert Panel
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