



## National Association of State Auditors, Comptrollers and Treasurers

September 17, 2010

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### CONTACT INFORMATION

Headquarters Office  
449 Lewis Hargett Circle  
Suite 290  
Lexington, KY 40503-3590  
(859) 276-1147  
Fax (859) 278-0507

Washington Office  
444 N. Capitol Street, NW  
Suite 234  
Washington, DC 20001  
(202) 624-5451  
Fax (202) 624-5473

[www.nasact.org](http://www.nasact.org)

Mr. David Bean  
Director of Research  
Governmental Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

Dear Mr. Bean:

On behalf of the National Association of State Auditors, Comptrollers and Treasurers we appreciate the opportunity to respond to the Governmental Accounting Standards Board's Preliminary Views (PV), *Pension Accounting and Financial Reporting by Employers*.

In our July 29, 2009, response to the GASB's Invitation to Comment (ITC), *Pension Accounting and Financial Reporting*, we indicated our preference for the net pension obligation (NPO) approach; that is, a liability should be recognized when the employer does not pay the annual required contribution. We remain concerned with GASB's belief that it is possible to fully segregate the accounting for pension liabilities from funding those liabilities, and we are not convinced that the net pension liability, as described in the PV, would provide more reliable or useful information than existing requirements. Additionally, there is concern that information provided by the net pension obligation – that is, whether the employer has been funding annual contributions on a reasonable actuarial basis – would be lost if the net pension liability approach in the PV were adopted.

There is also concern that the net pension liability approach will cause fear and misunderstanding among financial statement readers who will interpret this as being an unfunded obligation as of the balance sheet date, when in fact it represents the obligation to be funded by contributions and earnings over time. As long as the contributions are fully made, the obligation will be fully funded at the end of the period. We can see how this will cause legislators to make significant and detrimental changes to pension plans, even those that are healthy, sound and being funded properly.

Given our preference for the NPO approach, we offer the following feedback in response to the specific questions posed by GASB in the PV. Also, due to the significance of this issue, we are including an appendix to this letter that contains some of the minority comments that we believe the Board should consider as it continues deliberation of this important topic.

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

We agree. An employer agrees that in exchange for current services provided by the employee it will provide to the employee current financial benefits plus future compensation. When the employer commits to a total compensation package, the employer receives the benefit of that exchange and incurs an obligation to its employees. In addition, the plan only represents the mechanism for accumulating resources to pay employee benefits.

## **Issue 2: Liability Recognition by a Sole or Agent Employer**

**2a.** We agree. Governments have proven in their actions that they have little or no discretion to avoid a pension liability. Typically changes in pension benefits are made prospectively from a particular point in the future because an agreement has already been made with current employees for which an exchange transaction has already occurred.

However, our membership also pointed out that a state government, as an employer, may have some level of discretion to enact laws which would allow it to change the amount of employer resources to be sacrificed. Therefore, the final component of the definition of *liabilities* does not appear to have been met completely. For example, the New Mexico Supreme Court recently confirmed that the New Mexico legislature's action in increasing state employee contributions to its public pension plan by 1.5 percent was constitutional, and other states have proposals outstanding that would require higher employee contributions, reductions in benefits, and/or reductions in cost of living adjustments.

**2b.** We agree. While the amounts of future benefit payments are uncertain, the recognition of an estimate using assumptions and judgments is more reliable than no recognition of liability at all. We also believe that the types of estimation methods for measuring net pension liability are well developed and have been used long enough to produce reliable information.

However, we believe GASB should include a discussion on where a government with both governmental and business type activities, and multiple major funds, will report the liability.

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

**3a.** We agree. We believe these are all relevant factors in determining the amount of future benefits. In order to come to a reasonable estimate of future costs, it is logical to include factors that will have an impact on those costs. By requiring certain factors to be considered, uniformity between reporting entities is more likely.

**3b.** We believe that the employer's experience or demonstrated pattern of granting ad hoc COLAs over time serves as a good basis for representing management intent.

**3c.** We agree. We believe that using the long-term expected rate of return will best ensure alignment between projected and actual funding of pension liabilities in plans with a sound long-term funding policy. We agree with the Board that the unfunded portion of benefits should be based on a high-quality municipal bond index because sufficient assets for long-term investment have not been set aside to offset the long-term nature of the pension liability. However, we believe the board will need to clearly explain how the two rates will converge into one single rate (likely through illustrations).

**3d.** We agree. Requiring the use of the entry age actuarial cost method is appropriate for financial reporting as it will enhance comparability and understandability, and reduce the complexity in reporting. The level-percentage-of-payroll basis is appropriate as it more accurately assigns costs over the period of the employee's service.

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

**4a.** We agree. This recognition provides for a more consistent measure to enhance interperiod equity. It also spreads the costs across the employee's career which is consistent with the exchange transaction view.

**4b.** We agree. We believe that some plan asset leveling is necessary to prevent over-reaction to short-term volatility in the investment market. Cumulative differences of the fair value of plan investments outside the 15 percent corridor should be recognized immediately to reflect significant or other-than-temporary differences. We recommend the Board include detailed guidance and financial statement examples to ensure consistent and correct application.

**Issue 5: Recognition by a Cost-Sharing Employer**

**5a.** We agree. Any net pension liability should be the responsibility of those parties involved and be reflected accordingly.

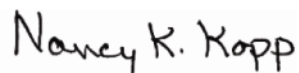
**5b.** We agree that use of the proportionate share of the annual contractually required contributions is a rational method for portioning out each employer's liability.

**Issue 6: Frequency and Timing of Measurements**

We agree that an actuarial valuation should be performed as of a date not more than 24 months prior to the employer's fiscal year-end. Given current economic conditions, the biennial approach provides a cost-effective solution for all sizes of state and local governments. However, due to the complex, interdependent variables being measured, we believe the update would require another actuarial evaluation to fully reflect the effects of all significant changes. We request that additional clarification or examples be provided on what would constitute a "significant change."

We appreciate the opportunity to provide our comments. Should you have any questions or need additional information regarding our response, please contact Kim O'Ryan of NASACT at (859) 276-1147 or me at (410) 260-7160.

Sincerely,



Nancy K. Kopp  
NASACT President

## APPENDIX

The preceding letter provides the majority position of NASACT based on responses to the PV received from 15 members. However, given the significant effect that pension liability measurement and recognition will have on state governments, we believe it is important to convey to the Board some of the concerns raised by states that may not be separately communicated to the Board and are not reflected in the preceding letter.

### Issue 1.

- One respondent believes that employees are likely to share in increased contributions to fund the net pension liability and the employer's liability should reflect that condition.

### Issue 2a.

- Three respondents believe the existing Net Pension Obligation based on the unpaid ARC best describes the employer's pension obligation because it is based on a proven methodology, it provides comparability, and it demonstrates whether the government is meeting its obligation to fund the plan over the long term.
- One respondent believes the ability of a government to avoid the outflow of resources in the event of actuarial necessity has not been clearly defined by the courts, and therefore, all required attributes of a liability have not been met.

### Issue 2b.

- Two respondents believe the Net Pension Liability is no more reliably measurable than the existing Net Pension Obligation because of the volatility of market valuation of pension assets and the significant assumptions involved in the liability valuation. They believe that using the end of period market value of pension assets in determining NPL is inconsistent with the general intention expressed by GASB to reflect pension costs over employees' careers. These members believe that using the MVA on a given day would introduce unnecessary volatility into the NPL and therefore, disagree with the PV that the NPL is measurable with sufficient reliability to be recognized in employers' financial statements. Concern was also raised about how the liability would be recognized in the employer's financial statements and the lack of flexibility in the preliminary views document.

### Issue 3a.

- Five respondents disagreed with the inclusion of ad hoc COLAs in the NPL calculation because they are discretionary, unlikely to continue in the current economic environment, or are not a legal requirement (significantly increasing the ability of the government to avoid the related outflow). Another respondent opposed the inclusion of any ad hoc COLAs citing the lack of legal liability.
- Two respondents believe their state's salary increase hiatus indicates that projecting salary increases does not reflect current economic realities. These respondents believe caution should be exercised in assuming that increases given in the past are a clear indication of future increases. They believe the look-back period should be kept short, and the current financial condition should be taken into consideration when projecting salary increases.
- One respondent believes that absent a legal responsibility, which cannot be established without individual employer actuarial evaluations, there would be no unavoidable outflow of resources.

### Issue 3b.

- Eight respondents cited the historical pattern as a reasonable basis for projecting ad hoc COLAs and one suggested tying the projection to a relevant index such as CPI.

Issue 3c.

- Three respondents disagreed with the proposal for a single blended rate because it was not adequately explained and/or deemed to be not practicable.
- Three believe the municipal bond index rate is inappropriate as a discount rate for the unfunded portion because it is not relevant to investment returns likely to support (or not support) an unfunded liability.
- One respondent prefers to retain the long-term expected rate of return for the entire liability because it best aligns with the actual funding methods of the plan.
- One respondent suggested a short-term investment return rate should be used, similar to the current practice for unfunded OPEB benefits.

Issue 3d.

- Three respondents disagree with the proposed requirement to limit governments to using the entry-age method because they believe the government and the actuary are in the best position to select an actuarial method that reflects their unique conditions.

Issue 4a.

- One respondent suggested spreading the gains and losses over 15 to 20 years, which may be some amount of time longer than weighted average of expected remaining service.

Issue 4b.

- One respondent questioned the value of the entire deferral and corridor proposal.
- One suggested a 20 percent corridor.
- One approved of the deferral approach, but believes it should be applied without the 15% corridor.
- One believed the deferral approach was not consistent with the Board's view that increases and decreases generally offset over long term periods.
- One proposed traditional asset smoothing, but with some limits like a 15% corridor and a closed smoothing period of no longer than four or five years.

Issue 5a.

- A number of respondents requested more information on the basis or methodology for allocating the liability on multi-employer plans.
- One agreed with proportional recognition of the employer share, but believes that employees would likely be required to participate in the employer's "liability."
- One expressed concern that recognizing the new and highly volatile pension liability would cause governments to withdraw from defined benefit programs.

Issue 5b. A majority of the respondents agreed with the proportionate share approach and offered no alternatives, however:

- One thought the method lacked the precision necessary given that participant funding decisions would be based on the allocation.
- One is concerned about the potentially significant effect of changes in the proportionate share from period to period and suggested deferred recognition.
- One believes individual employer actuarial valuations would be necessary for accuracy.
- One believes the Board should include a discussion of the effect of unpaid ARCs on the calculation of proportionate share of the NPL.
- One believes it is important for cost sharing employers to disclose their dependence on another government in the cost sharing pool if the other government controlled the contractually required ARC.

Issue 6.

- Three questioned the cost versus benefit of the valuation update and believe that the complexity involved would mandate a full actuarial revaluation.
- Two respondents believe that annual valuations should be required because older valuations do not capture current economic conditions and annual valuations could make updates to the balance sheet date unnecessary.
- Two expressed concern that valuation updates could not be performed in time to meet financial statement issuance deadlines.

General comments were offered as follows:

- Six respondents opposed the proposal citing the adverse implications of implementation at this time and the inability to guarantee separation of the pension reporting from pension funding in their state.
- One does not believe that the proposed treatment will result in more reliable or useful information.
- One, who supported the proposal, thought the differences between the GAAP reporting requirement and the funding philosophy and related valuation methodology should be described and explained in the financial statements.
- One indicated that this would be a very difficult standard to implement and would negatively impact the timely completion of audited financial statements.