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Since 1937

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Dear Sir;

On behalf of the Florida Government Finance Officers Association (FGFOA), we are pleased to respond to the GASB's Invitation to Comment on *Pension Accounting and Financial Reporting*. These comments were prepared based on a review by the FGFOA members, its Technical Resources Committee, and the Board of Directors.

Chapter 2: Focus of Accounting and Financial Reporting for Pensions

- 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 recommend that the employer's financial statement present only information relevant to its financing of the pension obligation. We believe that this information is far more important for most users to have than information about the initial incurrence of the benefit obligation.

If information about both processes were to appear in the same financial statement, it would be too confusing for the average user (even for the average CAFR user) to sort out the differences. Pension and OPEB accounting and actuarial concepts are challenging enough as is. We can envision various unintended consequences related to reporting multiple measures of pension costs and liabilities, not the least of which are (a) moral hazard because misleading and confusing data results in decisions based on other biased inputs and (b) a lack of transparency because too much peripheral or irrelevant information obscures the most important numbers. There should be compelling reasons for requiring the presentation of information about both processes in the same financial statements.

Additional Note disclosures about the financing of the pension obligation might also be helpful, such as a reconciliation of the unfunded actuarial accrued liability from the most recent valuation to the previous one showing changes therein by major sources.

Chapter 3: Issues Related to Liability and Expense Recognition

- 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.)**

Both a and b seem to satisfy the definition for sole and agent employers. However, a more practical approach would be to continue to recognize the NPO as a liability which appears on the Statement of Net Assets, while the total unfunded actuarial accrued liability for financing purposes should continue to be disclosed in the Notes. This recommendation is consistent with Alternative 1, as described in Chapter 3 of the ITC. The following reasons are presented herein for taking this position.

- Not a fixed liability. Actuarial calculations of pension and OPEB costs and liabilities are based on a lot of assumptions. Emerging experience never matches the assumptions. Not until the last person receives his or her last pension check will we know if the actuarial measurements were accurate. Every year, there is a remeasurement of the liability using new employee data and new fund data (and sometimes new assumptions) causing fluctuations in results. That volatility may be acceptable in expense recognition where it can be amortized, but that volatility may not be appropriate for liability recognition where little can be done to mitigate it (aside from asset smoothing). The actuarial model for calculating the liability is extremely thorough, scientific and reliable. However, the volatility may disqualify it from a balance sheet liability. This presents a problem for Alternative 3, while Alternative 2 is the worst because of the volatility in both expense and liability recognition. Such annual volatility is not relevant to a long-term obligation such as government pension and OPEB plans.
- Consistency with cost sharing employers. If a full actuarial pension liability (either for benefit incurrence or for financing) were recognized as a liability on the Statement of Net Assets for sole and agent employers, there would be an inconsistency with cost sharing employers. As described below under Questions 7, the pooling nature of the cost sharing plan prevents any reasonable actuarial method to assign a total unfunded actuarial accrued liability to an individual cost sharing employer representing its own liability for its own members. Consequently, cost sharing employers should not and cannot have any liability recognized beyond the cumulative shortfalls in their contributions. Adopting Alternative 1 for sole and agent employers maintains consistency with cost sharing employers.
- Recognition and disclosures taken together. The annual required contribution (ARC) together with the current and additional information disclosed in the Notes and Required Supplementary Information (RSI) is sufficient financial statement information to hold public officials accountable. If the unfunded actuarial accrued liability is in the Notes, it does not need to be recognized as a liability in order to satisfy the accountability or usefulness objectives.
- Spread-gain actuarial cost methods. The Aggregate cost method does not even have a naturally occurring unfunded actuarial accrued liability. That is exactly why Statement No. 50 requires disclosure of the Entry Age Normal cost method's actuarial accrued liability in the Notes for any sole or agent employer whose plan uses Aggregate for its annual required contribution. The other two currently permissible spread-gain methods have an unfunded actuarial accrued liability, but the annual actuarial gains and losses are not worked into those liability numbers. This makes them poor candidates for recognition of their respective liabilities. Spread-gain actuarial cost methods present particular challenges for Alternatives 2 and 3. If the solution were to assign the Entry Age Normal (EAN) unfunded actuarial accrued liability as the liability to be recognized for all plans using spread-gain methods for their expense recognition that would create an inconsistency. Public officials would be held accountable for annual expense under one method (EAN), while held accountable for paying down a liability using another (the plan's chosen spread-gain method).

- Accounting trouble with Alternative 3. There are troublesome accounting ramifications for recognizing a full unfunded actuarial accrued liability while amortizing it and its annual changes as part of the expense. The remaining unrecognized portion of the total must go somewhere. Restating beginning balances does not seem appropriate. Adding a deferred pension cost equal to the recognized liability would appear to many preparers and users as defying common sense. Making a “below-the-line” annual adjustment relating to the unrecognized portions would be a new concept for many to embrace.

On balance, it appears that retaining the current NPO structure, as under Alternative 1 is a better choice, provided additional information is added to the Notes or RSI.

- 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 inter-period 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.**

Deferred recognition has more practical advantages.

It might seem that immediate recognition of changes in the liability is more theoretically faithful to the concept of inter-period equity, whether the liability measured under a benefit incurrence viewpoint or a financing viewpoint.

Even immediate recognition, however, does not achieve inter-period equity. There is no accounting or actuarial model which achieves inter-period equity for defined benefit pension or OPEB plans as we know them. Naturally occurring actuarial gains and losses, changes in actuarial assumptions and methods, and retroactive benefit improvements effectively change the obligation’s value allocation to past years in a retroactive way. Once the past years are closed it is impossible to restate or open past years again. Recognizing all those changes immediately, all in the current year, does not achieve inter-period equity. Such a practice must be balanced against other competing goals.

In addition, immediate recognition of actuarial gains (and losses) and changes in actuarial assumptions and methods would result in extreme and unnecessary volatility in the measurement. Any perceived consistency with inter-period equity is offset and nullified by its lack of usefulness.

Deferred recognition of such changes has its advantages, as long as parameters are specified to prevent abuse and to tie the amortization periods to the years over which the employer enjoys the benefit of the services rendered by the covered workforce. This preserves a degree of consistency with inter-period equity.

Chapter 4: Approaches to Measurement

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

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

Yes. These are part of the plan promises and, thus, should be included in the projections of future benefits payable.

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.

Yes, if they are part of the substance of the employment agreement. However, if the employer changes its pattern or practice, that should constitute a change in the substantive plan.

c. Projected future salary increases

Yes. With a financing view of the employer's liability, estimated future levels of salary increases should be included in the projected future benefit calculations.

d. Projected future service credits.

Yes. With a financing view of the employer's liability, estimated future service credits should be included in the projected future benefit calculations.

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.**

Clearly and most certainly, the estimated long-term investment yield for the plan should be the basis for determining the discount rate.

Alternatives b, c, and d are based on a market price view of the pension liability. They are inadequate attempts at a fair value measurement. If a fair value measurement attribute for pension liabilities were adopted by GASB, alternatives b, c, and d would not represent fair value. Furthermore, other significant changes in the accumulated projected benefit stream (benefit incurrence measurement) should be considered if a fair value measurement attribute were adopted. There is a lot more to measuring pension benefit incurrence liabilities at fair value than can be described in this response.

However, neither fair value nor any other market-based approach is an appropriate measurement attribute for government pension obligations. Our goal should be to measure the long term cost to taxpayers rather than the market price to settle the obligation. A pension liability should not be treated like a derivative or other asset held for sale or exchange.

Different investment policy guidelines among plans will result in different expected long-term rates of return. If all plans were required to use the same interest discount rate, they would lose an important element of comparison. Measuring the long-term cost to taxpayers requires that we use the expected long-term rate of return for the plan assets.

Consequently, we ask that the selection of the interest discount rate be left to the plan boards on the advice of their professionals and their best judgment for determining a plan's expected (best estimate) long-term rate of return.

Chapter 5: Issues Related to the Use of Actuarial Methods

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?

The same six actuarial cost methods should continue to be permitted for measurement purposes.

There is a fundamental transaction and governmental structure between the employer and the plan. As part of that structure, the plan requires the employer to finance the obligation pursuant to a particular actuarial cost method. The amounts and pattern inherent in that financing obligation is what the employer should be measuring for their financial reporting purposes. Not all plans adopt the same actuarial cost method for their respective transactions and funding requirements from the employer.

Requiring all employers to measure the pension obligation they owe to their plans using the same actuarial cost method, in the name of comparability, would violate Paragraph 68 of Concept Statement No. 1:

Comparability implies that differences between financial reports should be due to substantive differences in the underlying transactions or the governmental structure rather than due to selection of different alternatives in accounting procedures or practices.

Forcing all plans to use the same cost method fails to recognize the substantive differences in the underlying transaction between the plan and employer. That diminishes comparability and transparency rather than enhancing them.

- 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?**

A single maximum amortization period applicable to all sources of changes in the unfunded actuarial accrued liability would 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?**

Yes, because the reasons that give rise to such changes are different and should be handled differently.

- 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 a 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?**

The maximum amortization period for changes in the unfunded actuarial accrued liability resulting from benefit changes should be substantially reduced from its current 30 years. Some possible candidate could include (a) the length of the collective bargaining agreement for those changes agreed through collective bargaining, (b) a flat 10 or 15 year maximum, or (c) the average future working years expected for those who benefit. Ad hoc COLAs or other increases affecting only inactive members might be candidates for immediate recognition, or amortized over no longer than a fixed five years.

Similarly, any changes in the unfunded actuarial accrued liability resulting from changes in actuarial assumptions or methods which arise in connection with a benefit changes should have the same maximum amortization periods as apply to the benefit change. Examples of this could be lower retirement age resulting in changes in expected retirement rates. However, assumption or method changes which are made at the same time are not considered "in connection with" benefit changes for this purpose if they are not directly related to emerging experience which is expected to change because of the benefit change.

Changes in the unfunded actuarial accrued liability caused by actuarial gains or losses are different. They are not the effect of direct action taken by the employer or the plan, as with benefit changes. They are, theoretically, random changes. In some years there will be increasing changes and in some there will be decreasing changes. Theoretically, the various changes will offset each other over time. It is impossible to set a specific period of time over which the annual changes are expected to offset each other. But it should not be expected to be shorter than 20 years. While a period of 30 years might acceptable, so might 25.

Similarly, changes in the unfunded actuarial accrued liability resulting form changes in actuarial assumptions and methods (other than those changed in connection with a benefit change) should have the same maximum amortization period as changes resulting from actuarial gains and losses.

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?

Open amortizations should no longer be permitted, except possibly for changes resulting from actuarial gains and losses.

We are ambivalent about negative amortizations, which occur when using level percent of pay methods. These methods expect unfunded liabilities to increase for a period of years before beginning to decrease because the amortization payment (starting out low and ending up high) would not be sufficient to cover interest on the liability for a period of years until it increases to that level. In one sense, it seems reasonable to always require the amortization payment to be at least equal to the interest on the liability.

However, in terms of real dollars, the liability and amortization payment are not really increasing, and an amortization payment which is level as a percent of pay is better for budgeting and is more consistent with the normal cost which is also calculated level as a percent of pay. In addition, for the reverse, it seems not appropriate to credit at least interest when the amortization credit is lower for changes which produce a reduction in the unfunded actuarial accrued liability, especially if the credit results in a total annual required contribution less than the normal cost. Finally, for actuarial gains and losses, level percent of pay amortizations provides more time for the gains and losses to offset each other.

If at least interest were required to be expensed for future increases in the UAAL resulting from benefit changes, gains and losses and changes in assumptions and methods, then we request that any current UAAL being amortized on a level percent of pay basis be permitted to continue on that basis (without the minimum of interest) until fully amortized, as a transition provision.

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?

Clearly, in a financing or funding view of pension accounting and under Alternative 1, whatever method of smoothing asset is permitted under actuarial standards should be permitted for accounting standards for expensing and disclosure.

The market value of the assets is readily available for all to see, in the plan's financial statement or in the employer's presentation of fiduciary funds.

For reasons similar to those provided under Questions 6a, however, the measure of the annual required contribution recognized and the unfunded actuarial accrued liability disclosed should be based upon the actuarial value of assets adopted by the plan and which forms the basis of the funding obligation's pattern established by the plan for the employer. Using either a market value or a prescribed smoothing method for the recognition of expense or disclosure of liability, in the name of comparability, would introduce an artificial and misleading methodology – one which deliberately ignores the actual amounts and patterns of the employer's actual pension funding obligation to the plan.

Chapter 6: Accounting by Employers in Cost-Sharing Plans

- 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?**
- 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.**
 - The relationship does differ in economic substance, and current measurement and recognition requirements are appropriate; however, additional disclosures by cost-sharing employers are needed.**
 - 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.**

The relationship between a cost sharing employer and its cost sharing plan is very different in substance from the relationship between a sole or agent employer with its plan. The whole point of cost sharing is to pool the costs and liabilities, so that there is no longer any way to represent the past or future cost sharing employer contributions as applied to benefits for its own employees.

Therefore, the cost sharing employer should not be required to contrive some artificial cost or liability and call it attributable to its own employees. The employer's own individual costs and liabilities are lost in the pool.

However, it would be useful to require the cost sharing employer to report certain information concerning the cost sharing plan (such as funded status) in its own Notes.

Chapter 7: Issues Specific to Reporting by Plans

- 8. Which of the following should a pension plan report as its liability in regard to pension benefits, and why?**
- A liability for benefits currently due and payable**
 - The accrued benefit obligation, however measured.**

A liability for benefits currently due and payable.

- 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?**

Only if there are changes arising due to benefit changes adopted by the plan's trustees; then only in the plan's Note disclosures. The effect on the employer for financing a benefit change (which is adopted either by the plan trustees, by the employer or mandated by the state) should be a Note disclosure in the sole or agent employer's financial statement. That is where the accountability for such decisions resides.

a. If yes, which financial report(s) should contain that presentation: the employer's, the plan's, or both? Why?

Refer to response above.

b. If yes, should the presentation be a basic financial statement, a note to the basic financial statements, or required supplementary information? Why?

Refer to response above.

Thank you for the opportunity to respond. Feel free to contact me at (863-402-6519) or rhelms@hcbcc.org.

Sincerely,

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