California State Teachers'
Retirement System
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Director of Research and Technical Activities
Governmental Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

**Re: Project No. 34**

We appreciate the opportunity to comment on the Governmental Accounting Standards Board's ("GASB's" or "Board's") Invitation to Comment *Pension Accounting and Financial Reporting* dated March 31, 2009 (the "ITC"). The California State Teachers' Retirement System ("CalSTRS"), with a $161.5 billion portfolio as of June 30, 2008, is the second largest public pension fund in the United States. CalSTRS administers cost-sharing multiple-employer pension plans, a tax-deferred defined contribution plan, and other retirement, disability and survivor benefits for California's 833,000 public school educators and their beneficiaries. The Teachers' Retirement Law, part of the California Education Code, established these programs with CalSTRS as administrator.

We have provided our overall observations on the proposed approaches set forth in the ITC below, and have included our responses to all questions from the ITC in Appendix I.

In general, we believe the existing pension accounting and financial reporting standards achieve the objectives of accountability, interperiod equity and decision usefulness. The current standards focus on how an employer finances its pension obligation and whether the employer has made payments to the pension plan in accordance with the actuarially determined annual required contributions ("ARC"). The ARC is calculated with the expectation that it will be sufficient over time to fund the future benefits promised to plan members. Therefore, we feel that the employer should be held most accountable to its performance against these funding objectives.

In addition, it is our belief that a focus on the employers' performance against the annual required contributions achieves the objective of interperiod equity. Users of the financial statements will be able to determine if current period revenue is sufficient to meet the annual funding requirements, or whether these funding requirements are being passed on to future taxpayers. This leads to the objective of decision usefulness. With a focus on how the employer finances its pension obligation, decision makers will be able to clearly assess whether employers are on course to fund the pension benefits or whether changes need to be made to help employers achieve their pension funding objectives.

Finally, we believe that the relationship between a cost-sharing and a sole or agent employer differs dramatically in economic substance. In cost-sharing plans, the employer is not responsible for contributions above their set contribution amount. Any under funded obligation or shortfall between the ARC and actual contributions is not a liability of the employer. It is therefore not reasonable to expect that measurements and recognition requirements would apply consistently between cost-sharing plans and sole or agent employer plans. While we feel that the current measurement and recognition requirements are appropriate, we also believe that additional disclosures by cost-sharing employers could be useful to the readers of the employers' financial statements.

CalSTRS, along with others, have signed a separate ITC response from the National Association of State Retirement Administrators ("NASRA") and the National Council on Teacher Retirement. While we substantially agree with the responses included in the NASRA-NCTR letter, there are some minor differences between our responses and NASRA's responses to questions 4, 7 and 8.

Thank you for your consideration of our views on this issue.

Sincerely,

Christine Ford
Chief Financial Officer

Attachment

cc: Jack Ehnes, Chief Executive Officer, CalSTRS

We offer the following responses to the questions posed in the ITC, dated March 31, 2009:

*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.***

CalSTRS believes that governmental accounting and financial reporting should focus on (B), the process by which an employer finances its projected future cash outflows for defined pension benefits. A focus on financing reflects a long-term perspective by concentrating on annual contribution requirements and an employer's ability to meet those requirements. The annual requirements are calculated with the expectation that they will be sufficient over time to fund the future benefits already earned by plan members, as well as the future benefits expected to be earned by plan members throughout their careers.

We believe the employer's performance against the current contribution requirements is the best indicator of whether current or future tax payers are paying for the services previously provided. The funding approach achieves the objective of accountability by directing the user's attention to whether an employer is meeting its current contribution requirements. In contrast, focusing the user's attention on the total obligation would detract from whether current-year revenues are sufficient, or being used, to meet the annual funding obligations and would therefore mask interperiod equity.

CalSTRS believes that the currently provided schedule of funding progress in the required supplementary information ("RSI") and the disclosure requirements predicated by GASB Statement No. 50 allow the user to see the plan's long-term funding needs. These disclosures and supplementary information supply sufficient information about the obligations that have been incurred.

*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.)***

We believe that both option (A) and option (B) meet the conceptual definition of a liability. However, we feel that option (A), the cumulative difference between the annual required contributions ("ARC") and the amounts the employer has actually contributed to the plan, is the better way to measure and report the liability.

The ARC is calculated so that if the required contributions are made by the employer each year, the plan will have sufficient assets to cover future benefit obligations. By focusing on whether the employers are making contributions sufficient to cover the ARC, we are focusing attention where it is most needed. Reporting a liability equal to the cumulative difference between the ARC and the employer's actual contributions, enables users of the financial statements to fully understand the employer's performance against these obligations. If employers were required to record the unfunded accrued benefit obligation, it would draw attention to a number that employers are less accountable for, because it is inconsistent with their funding requirements. Therefore, the users of the financial statements would not be able to clearly assess whether current period revenues are sufficient, or are being used, to pay for current period liabilities.

The actuarial measure of the unfunded accrued benefit obligation is an actuarial funding target and should not be used as an accounting liability. The obligation is based upon events that will occur well into the future, rather than strictly on services rendered prior to the measurement and reporting date. For example, the actuarial projections include anticipated salary increases and cost of living adjustments, as well as projected service terms. Further, the reliability of the total accrued benefit obligation is questionable. Any estimate of the obligation includes significant assumptions about future events and represents a broad estimate of the total costs of future benefits measured at a particular point in time. Minor variations in actuarial assumptions could cause the obligation to fluctuate by highly material amounts. The subjectivity and complexity of the unfunded accrued benefit obligation would mean that the average user of the financial statements would not possess the expertise required to fully understand the liability being reported.

***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 believe that, in theory, option (A) is the most consistent with the concept of interperiod equity. However, the recognition of events and transactions that affect the unfunded accrued benefit obligation as they occur would also require the reporting of the unfunded accrued benefit obligation. As we discussed in our previous responses, we believe that recording the unfunded accrued benefit obligation would detract from interperiod equity. The employers are most accountable for meeting the actuarially determined annual required contributions. If attention is

drawn away from whether employers have met their annual requirements, it will result in masking interperiod equity. The financial statements will no longer highlight whether current period revenues are being used to meet the pension obligations, or whether the current contribution requirements are being passed along to future taxpayers. As such, we believe that, in reality, option (B) best meets the conceptual definition of interperiod equity.

***Chapter 4: Approaches to Measurement***

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

- ***a. Automatic COLAs***
- ***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***
- ***c. Projected future salary increases***
- ***d. Projected future service credits.***

We believe that all of the above projected future changes should be included in projected pension benefits, assuming they are probable and estimable, based upon historical data and / or contractual obligations. These variables will affect future cash outflows for benefit obligations. Excluding them would not reflect the full value of the employment-exchange transaction. There should be sufficient disclosure to allow users of the financial statements to determine the nature and amount of projected future changes included in the projection of pension benefits.

***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.***

CalSTRS believes that option (A), the estimated long-term investment yield for the plan, is the best basis for determining the discount rate. The Plan is investing money, not borrowing money, in order to pay future benefits. Therefore, discounting the projected benefits at the investment yield most appropriately reflects the present cost of the plan. This assumes that the long-term investment yield is supported by historical returns on plan assets and is based upon reasonable expectations for the future.
Using a borrowing rate, which could fluctuate more widely over time, would add unnecessary volatility to the calculation of the present value of projected benefits. Finally, requiring all employers to use the same rate (i.e., the risk-free rate) ignores inherent differences between plan investment strategies.

***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?***

We believe it is most important to maintain the link between accounting and funding. Therefore, we believe the method used for accounting and financial reporting should be the same method used in the actuarial funding valuation. All of the six currently allowable actuarial methods are appropriate, depending on the type of plan. However, we do not object to reasonable restrictions on the number of allowable methods in order to improve comparability between plans and reduce subjectivity in the measurement and financial reporting of pension information. In addition, the average user does not possess the expertise to fully understand the nuances of six different actuarial cost methods and would therefore benefit from a reduced number of measurement methods.

If the Board were to decide to reduce the number of acceptable actuarial methods, we would recommend retaining the entry age and projected unit credit methods. As the ITC points out, these methods are currently used by 90% of large public pension plans. Therefore, standardizing to these two methods would require fewer employers and plans to change actuarial cost methods or to use a method different from the one they currently use for funding purposes. Further, in contrast to the frozen entry age, frozen attained age and aggregate actuarial methods, the entry age and projected unit credit methods provide a measure of the employer's accrued benefit obligation and a basis for disclosing the funded status of the plan.

- ***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?***

CalSTRS believes that the currently allowed maximum amortization period of 30 years is appropriate and should continue to be permitted. For CalSTRS' purposes, the funding goals are designed to pay for the plan's unfunded accrued liability over a period of 30 years. It is unlikely that the funding amounts would increase as a result of reducing the maximum amortization period for accounting purposes. Therefore, the current accounting rules reflect the funding reality. Also, we believe that the key to sufficiently financing the pension obligation is consistency. We therefore do not feel it is beneficial to frequently adjust the amortization period, as would be required if the amortization period were based on a variable factor, such as the average remaining service life of active plan members.

We also concur with the reasons cited in the ITC in support of a 30 year maximum amortization period. We believe that 30 years is appropriate because it represents the notional length of a full career in government service. We feel that the amortization of actuarial gains and losses over a longer period of time is appropriate because it smoothes out short term fluctuations that are not relevant from a long-term perspective. Finally, we agree that retroactively applied benefits have intangible and indirect future benefit to the employer and to taxpayers by helping to retain existing employees and recruit new employees.

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

CalSTRS believes that different amortization periods should be allowed, but they should not be mandated. Different amortization periods may be appropriate for different types of changes to the unfunded accrued benefit obligation. However, the appropriate amortization periods will vary for different types of plans. Accounting standards should apply broad ranges for any mandated amortization periods.

If the Board were to decide to require different amortization periods for different types of changes, we feel that actuarial gains and losses should continue to be amortized over the maximum period of 30 years. We believe that these changes will even out over time and that the obligation should not be impacted by short-term fluctuations.

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?***

As stated in our response to question 6(c), CalSTRS believes that different amortization periods should be allowed, but they should not be mandated. The maximum period should remain at 30 years. Some actuarial gains and losses, such as investment gains and losses are expected to even out over the long run and therefore can easily be amortized over a 30 year period. Other changes such as benefits that are applied retroactively to past periods of service are, in reality, promises of compensation to encourage or obtain future service from current employees. Applying the benefit to past service is usually only a convenient way to allocate the promised compensation. Otherwise, if the benefit was, in reality, for past service, the retroactive benefit would be paid to all former employees as well. Therefore, this benefit properly applies to a future period and should be expensed over the future period that the compensation benefits the employer.

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 the continued use of both open and closed periods, both of which are presently utilized by CalSTRS. We support an open amortization period because it accommodates amortization of the total unfunded accrued benefit obligation as a single amount. Separate amortization periods for each component would increase complexity of the actuarial valuations for accounting purposes. Also, an open amortization period avoids the abrupt recognition of expenses that could occur for changes in components that are at, or close to, full amortization. We have one program that utilizes a closed amortization period, because the program is closed to new members. This illustrates that the appropriate use of open and closed amortization periods will depend on the type and status of the plan in question. We therefore believe that both methods should continue to be allowed. We also believe that both level percentage of pay and level dollar amount amortization methods are appropriate in different circumstances and both should continue to be permitted.

*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?*

We believe the current average market value technique should continue to be allowed. Amortizing the effects of short-term appreciation and depreciation in fair values over a reasonable period of time (e.g., three to five years) acknowledges fluctuations in market values, while mitigating the risk of overreaction to short term fluctuations. Further, as this technique smoothes both positive and negative fluctuations, it reduces the possibility of overly optimistic reactions to higher than expected market returns. This methodology emphasizes the long-term nature of pension liabilities.

*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?***

***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.***

We agree most with viewpoint B. The relationship differs dramatically in economic substance. In cost-sharing plans, the employer is not responsible for contributions above their set contribution amount, which is set by statute for employers participating in CalSTRS' plans. Therefore, any under funded obligation or shortfall between the ARC and actual contributions is not a liability of the employer. It is not reasonable to expect that measurements and recognition requirements would apply consistently between cost-sharing plans and sole or agent employer plans.

CalSTRS feels that current measurement and recognition requirements are appropriate; however, additional disclosures by cost-sharing employers would be useful for the readers of the employers' financial statements. Employers could provide additional information instead of their current practice of referring the reader to the Plan's financial report. Requiring users to obtain a second report in order to fully understand the funded status of a pension plan is not in line with the financial reporting principle of accountability. In the RSI, the employer could report on the funding progress of the pool in order to identify their potential exposure to increased costs associated with plan liabilities. We emphasize, however, that it is not practical for employers to provide their proportionate share of the unfunded obligation or the funding progress. All disclosures will need to be provided in total for the overall pool.

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

The Plan should report option A, a liability for benefits currently due and payable, which is the option that is most consistent with the definition of a liability per GASB Concepts Statement No. 4. The accrued benefit obligation, on the other hand, is not an obligation of the Plan.

***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?***

CalSTRS supports including a presentation of changes in the unfunded accrued benefit obligation in the plan's required supplementary information. We believe this supplementary data is relevant to various users of the financial reports. Further, the basic information is already captured in the Schedule of Funding Progress. Therefore, the incremental cost of preparation of a presentation of changes in the unfunded accrued benefit obligation would be relatively minor.