Governmental Accounting Standards Board
401 Merritt 7
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July 31, 2009

RE: Response to Invitation to Comment – Pension Accounting and Financial Reporting

Dear GASB:

The New York State Teachers' Retirement System (the System) accepts your Invitation to Comment (ITC) on Pension Accounting and Financial Reporting 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.**

The process by which an employer finances its projected future cash flows, is the most critical and appropriate way to achieve the financial reporting objectives of accountability and decision usefulness. Employers are responsible for providing the benefit payments promised by the plan, and typically set aside funds in advance to provide for this obligation. The System, and many other pension plans, are funded in accordance with an actuarial funding method, and contributions are determined and made annually in accordance with the method selected.

It is most critical that financial reporting provide information about how an employer is progressing with respect to making the contributions required by the funding method of the pension plan. Pension benefits can be promised and accrued but this obligation will have little meaning in the long run if not properly funded. The employer's financing of this obligation is really the heart of the matter. The current statement, GASB Statement No. 25, provides a satisfactory framework.

With respect to item a, while providing some information about how the employer has incurred this obligation would be a worthwhile endeavor, we have some concern here that the present value of accrued benefits (PVAB) not be a distraction, since the PVAB is highly subject to the actuarial assumptions used in the calculation, and may not have a direct relationship to the actuarial funding method being followed. This information will not be useful if it is misleading and a frequent source of misinterpretation. It would be detrimental if it provides a pretext for a reduction or elimination of a required plan contribution.

With respect to interperiod equity, the use of an actuarial funding method satisfies this requirement virtually by definition. Actuarial funding methods are generally designed to allocate the cost of benefits to each year as a level percentage of payroll. This achieves interperiod equity. In practice there are many assumptions regarding future experience that go into the actuarial valuation process, and the reflection of the actual experience realized versus what was assumed leads to adjustments in the annual actuarial contribution rate. This is a normal result and reflects the risk involved in being responsible for funding a defined benefit plan. If assumptions and methods are reasonable, the adjustment of the employer contribution rate is not a violation of interperiod equity.

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.)**

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, meets the definition of a liability. The arguments in the ITC presented in items 18b and 18c on page 20, and 23c and 23d on page 23, are the most compelling. The unfunded accrued benefit obligation is not precisely defined. The accrued benefit obligation is highly dependent on the actuarial assumptions utilized in the calculation. This item could change dramatically year to year depending on how the assumptions are changed. Again we are concerned about the potential for misinterpretation. It is not clear that this would provide a sufficiently reliable measurement.

The current practice of disclosing the unfunded actuarial accrued liability (UAAL) as part of the funded status disclosure, as required by GASB 25, in the notes to the financial statements and required supplementary information, is more appropriate. In our case the entire financial statements, including notes and supplementary information, are published each year in our annual report. The financial statements taken as a whole serve as the best source of information supporting accountability and decision usefulness.

As mentioned in item 23c we feel strongly that it is very important that disclosure reflect the actuarial funding method actually being used for funding purposes. This was a critical element of

GASB's change from GASB Statement No. 5 to Statement No. 25, and we feel the reasons upon which that decision was based remain valid in the current environment. Certainly disclosure should reflect actual funding practice. In light of the fact that elected officials may select reduced pension fund contributions as a way to reduce budgets, plan disclosures should not suggest that required contributions are not needed by the plan, and therefore may be reduced or eliminated, resulting in a short term decision with significant negative long term results.

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.**

Item b. above represents the preferred approach. Deferred recognition or amortization of some components of pension cost (other than the normal cost), in accordance with acceptable actuarial and accounting parameters, is a standard and acceptable part of a long-term funding plan. This would keep disclosure reflective of actual current funding practice, as well as comply with the concept 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 cost-of-living adjustments (COLAs)**

      Automatic COLAs should be included in the projection of future benefits.

   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.**

      Ad hoc COLAs should not be included in the projection of future benefits, unless it is determined based upon an employer's pattern of practice that they are substantively a

part of the plan terms. Rather this approach should mirror the "substantive plan" definition included in GASB Statements 43 and 45.

c. Projected future salary increases

As described in our response to Question 1, we believe financial reporting for pensions should be primarily based on the process by which an employer finances its pension obligation. Many plans are funded in accordance with an actuarial funding method, and this method typically includes projected future salary increases and projected future service credits in the projection of benefits. These are often two of several actuarial assumptions included in the process, including rates of probability on account of decrements such as death, withdrawal, disability and retirement.

d. Projectcd future service credits.

See response above.

5. What should be the basis for determining the discount rate used for discounting projected pension benefits to their present valne 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.

The estimated long-term investment yield for the plan is the appropriate rate to use for discounting projected pension benefits to their present value for accounting purposes. This method is aptly supported in the ITC in Item #20 on pages 33 and 34. The expected future rate of return on actual plan assets is the best rate to use for purposes of an orderly accumulation of plan assets in accordance with an actuarially developed funding program. This rate is intended to be a long term rate, and although in a given year the actual return may be higher or lower than the expected return, there is a reasonable probability that over the long-term the actual return will approximate this expected return. This has been our experience at the System.

Furthermore, unlike the other alternatives being considered, the expected long-term rate of return on assets does not change appreciably year-to-year, nor does it fluctuate with short-term changes in the economy. This renders it more appropriate for funding as well as financial reporting of the pension obligation, which is clearly a long-term liability. Tying this critical actuarial assumption to a yardstick that can fluctuate dramatically year-to-year could introduce tremendous volatility into the process, volatility not appropriate to a steady, long-term obligation. It would also break any link to interperiod equity if costs rose and fell dramatically year-to-year with changes in an interest rate index.

The risk-free rate is not an appropriate choice. Although the amount of equity-risk premium may change over time, there is no dispute that it has in fact been present, certainly over the long-term. Based on this it is reasonable to assume it will be there in the future. To use a risk-free rate would not be consistent with a reasonable expectation of future investment experience.

The employer's borrowing rate and the average return on high-quality municipal bonds are not appropriate choices either.

Notably both GASB, and the Actuarial Standards Board, with Actuarial Standards of Practice No. 27 (ASOP27) – *Selection of Economic Assumptions for Measuring Pension Obligations* – concluded that the expected long-term return on plan assets is the appropriate rate to use for discounting projected pension benefits to the present. Both of these groups carefully studied and debated this issue before reaching this conclusion. We agree with this conclusion and see no reason to change it at this point.

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?**

   All six of the currently permitted actuarial cost methods should continue to be permitted for accounting and financial reporting purposes. As stated above, it is imperative that financial reporting reflect the actual funding of the plan. Although this somewhat reduces comparability between employers, plans have different actuarial assumptions, as well as other valuation details, that render complete comparability impossible even if the same funding method were in use. In any event, the goal of comparability is a distant second to the goal of creating an environment of consistent financial reporting over time and one that is reflective of the plan funding actually occurring.

   At the System we use the aggregate funding method. This method has been in place for many years and it has worked well for purposes of appropriate asset accumulation. We understand that the method does not determine an accrued liability and the discrepancy this creates in determining the funded status of the plan. We feel that GASB remedied this shortfall by the issuance of GASB Statement No. 50, and we have had no issue conforming with the provisions therein. It is our recommendation that the aggregate funding method continue to be included in the list of acceptable funding methods.

We also note the strong potential for misunderstanding and misuse of information related to the disclosure of plan costs and funded status in accordance with a funding method not currently in use.

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

Amortization is a reasonable component of actuarial funding and a common and appropriate technique for the funding of a long-term obligation, such as for pensions. We believe that reasonable methods of amortization should be permitted for financial reporting purposes, just as they are for funding purposes. With respect to types of amortization (open, closed) and specific maximum and minimum years to permit, we have no specific recommendations. We suggest that GASB work with the actuarial profession to determine boundaries here that are acceptable to both groups.

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

Yes, different types of changes should lead to different amortization periods.

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?

We have no specific recommendation here but would defer to the actuarial profession.

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?

The amortization methods in use for plan funding should be permitted for accounting and financial reporting purposes.

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

The method of determining the actuarial value of plan assets used for plan funding should be permitted for accounting and financial reporting purposes to determine an employer's pension obligation and expense. ASOP No. 44 – *Selection and Use of Asset Valuation Methods for Pension Valuations* was developed by the Actuarial Standards Board

specifically to deal with issue. We recommend that GASB also follow this standard and consider permissible the asset valuation methods permitted by this standard. The market value of plan assets, we note, is readily available in the plan's financial statements.

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 bas 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 bas 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 current accounting approach to disclosure for individual employers in a cost-sharing multiple employer plan is adequate and should be continued. If additional disclosures are considered, with respect to the plan's unfunded obligation and funded status we suggest that they be on a plan-wide basis only. Attempts to divide up these values proportionately on a per-employer basis would be contrived and not necessarily provide useful information.

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 aud payable**
   b. **The accrued benefit obligation, however measured.**

   We believe that the approach taken in the current financial reporting model is appropriate, which we believe is represented by answer a. above.

9. **Should a prcseutation of changes in tbe 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 contaiu that presentation: tbe employcr's, tbe 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?

GASB may want to consider adding disclosure requirements relative to changes in the plan's actuarial accrued liability resulting from material changes to plan benefits made during the period. This information would best be included in the Notes to the Financial Statements, and perhaps historically over a five-year period in the Required Supplementary Information.

The System adopted the provisions of GASB 25 in 1995 and has been reporting in conformance with the provisions ever since. Our financial statements and disclosures have been readily available as part of our Annual Report, which in recent years has been available on the System's website. We are not aware of any instances in which our disclosures have not provided sufficient information for end-users. In light of this we recognize GASB's desire to re-evaluate its pension reporting format but caution GASB against making large scale changes that could have potentially severe and unintended consequences.

Thank you very much for the opportunity to respond to the ITC and provide our input.

Sincerely,

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cc: T. Lee