



Oregon

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Director of Research, Project No. 34
Governmental Accounting Standards Board
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Dear Director:

Thank you for the opportunity to respond to the GASB's Invitation to Comment on *Pension Accounting and Financial Reporting*. We would like to acknowledge the accounting staff of Oregon's Public Employees Retirement System for their significant contribution to the responses presented below.

Question 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

b. Utilize the process by which an employer finances its projected future cash outflows for defined benefits as long as the process uses and follows an actuarial funding program. We agree with the rationale provided in paragraph 14 of Chapter 2, especially the enduring nature of state and local governments. In private sector plans, where companies come and go, the focus on recording pension obligations as an offset to current revenue has merit.

Question 2: What obligations of a sole or agent employer associated with pensions meet the definition of a liability in Concepts Statement 4 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 employers unfunded accrued benefit obligation to employees for 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).
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- a. The liability should be the measure of the cumulative difference between the annual required contribution and amount actually contributed. In order for retirement plans to fully fund pension obligations, contribution rates need to be set based on the assumptions and methods of the plan. Shortfalls in the contributions that will provide full funding of benefits should be fully disclosed. This disclosure should not only provide for the shortfall, but also an explanation by the employer on how the shortfall will be remediated in future periods.

Question 3: Which of the following expense recognition patterns do you believe 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 the employer or by plan trustees within accounting parameters.
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- b. Deferred recognition of those components over which the employer does not exercise control, such as investment returns, change in life span or actuarial assumptions based on changes in experience. Additional service credits granted for prior service should be recognized when granted to facilitate interperiod equity.

Question 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

COLAs and ad hoc COLAs should be included in projected benefits if they are part of the plan and are definable. Liabilities should also reflect the present value of the impact from future estimated salary increases and estimated service credits at the time of a member's retirement. Liabilities should be projected as accurately and as realistically as possible. If COLAs or other increases are discretionary and not part of the plan, they should be excluded from the liabilities, as there is no guarantee that the liabilities will be realized in the future. Salary and service credits, if they can be estimated with relative accuracy, would contribute to the full disclosure of potential liabilities allowing contribution rates to fully fund those liabilities over time.

Question 5: What would be the basis for determining the discount rate used by 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

a. Over time, using the estimated long-term investment yield will help protect against a mismatch between projected funding of liabilities and the actual funding of those liabilities. Although this might cause short-term imbalances due market volatility, it should provide the best basis for establishing the true cost of the system and the setting of related contribution rates. A true 'risk-free rate' is ill defined and can be as volatile if not more volatile as using long-term investment projections. High-quality municipal bonds should not be used unless they are also the basis for the primary investment strategy of the plan.

Question 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 purpose to determine an employer's pension obligation and expense? Why?

Projected Unit Credit and Entry Age Normal should be the only actuarial cost methods allowed. The other methods are either little used or do not provide full disclosure of the financial condition of the plan. The lower number of available methods would allow greater comparability between plans without negatively affecting the reporting of most public pension plans. Having two methods, as opposed to just one, will allow some flexibility in tailoring the cost and related funding to the unique characteristics of each plan. Standards could be written to give guidance as to which method is used.

- 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?

Amortization periods should be set to minimize the impact of negative amortization and provide for a specific period of time over which unfunded liabilities are paid-off. Even a 30 year (closed) amortization allows for many years of negative amortization when contribution rates are based on a level percent of payroll (which is the most common method). A 25 year amortization could be considered as it reduces the possibility of negative amortization. Ideally, if the average or maximum service life of an active plan member is shorter than 30 years, that should be used as the plan's amortization standard. This will allow a closer match of funding to the underlying liabilities and avoid intergenerational issues. If this method is used, it should be changed infrequently and previous unfunded liabilities should not be re-amortized over the new period should there be a change. The use of a rolling (or open) amortization period should be strictly prohibited. An open amortization essentially perpetuates a regimen of ongoing negative amortization, which masks the full impact of unfunded actuarial liabilities on contribution rates.

- 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 amortization periods should be allowed for different types of changes to the unfunded accrued benefit obligation, within clearly established limits. GASB should set guidelines as to when a plan can deviate from its standard amortization period. For instance, generally agreed upon '100' year events such as the 2008 market losses or one-time events such as unfunded actuarial liabilities arising from the merger of two plans could be considered for special treatment. In general, however, amortization periods should not be used as a method by which a plan can manipulate unfunded actuarial liability levels or contribution rates.

- 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 where 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 should be 30 years (or less) or, preferably, the maximum remaining service life of the affected active plan members, whichever is shorter. Tying the amortization period to the remaining life of the members receiving the retroactive benefit would prevent intergenerational inequities. Once set, the amortization period should not be changed until the unfunded actuarial liability is fully covered.

- 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 same amortization method used in valuing the plan should be used for financial reporting purposes. While there may be value in adopting a single amortization method for all financial reports in order to provide for comparability between plan statements, it may not represent a meaningful representation of the plan's actual situation should the plan be valued using a different method. While comparability may be important, factual representation of the plan should be given priority. We strongly agree with the comments in paragraph 10c of this chapter that states: "Standards of accounting and financial reporting should focus on enhancing consistent financial reporting by individual employers over time rather than on the comparability of financial reporting among employers." Information has a cost. It should be useful to those who pay for it. Having said this, the number of amortization methods should be limited in number and guidelines provided as to when the approved methods are to be used.

- 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?

While reporting based on fair market value is preferable, GASB should allow plans to smooth changes in plan assets for up to five years. Public pension plans are perpetual and permitting the smoothing of asset changes is in congruence with this fact. However, the purpose should be to dampen the volatility in funded status and contribution rates that can come from fluctuation in asset balances. Even so, asset smoothing should be limited in length so as not to disguise permanent losses or gains. If a plan smoothes changes in asset values, it should

provide additional disclosure regarding the 'banked' asset loss or gain as of the valuation date.

Question 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 agency employers.

b. Additional disclosures by cost-sharing employers are needed. Currently, only the employer rate of the cost sharing pool is required to be reported by the plan to the employers. The disclosure of employer rates, by itself, does not provide meaningful information regarding the funded status, and thus the financial health of the cost sharing pool in which the employer participates. Because all of the liabilities of a cost sharing pool are the responsibilities of all the participating employers in that pool, the disclosure of the funded status of that pool is information that should be of importance to the reader of the cost-sharing employer's financial statements. As a result, the provision of a Schedule of Funded Progress, or something similar, for the (entire) cost sharing pool would provide the reader with insight into the size of the pool's liabilities, the funded status of those liabilities and the ability of the pool's participants to fund any reported shortfalls. In addition, it would be useful to disclose the employer's level of participation in the pool based on its current payroll for at least three valuations to show whether their level of participation in the pool is changing significantly.

Question 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

We strongly agree with the rationale presented in paragraph 8 of this chapter. Liabilities recognized in the financial statements of the plan should only be those relevant to the stewardship of the trustees and administrators of the plan. The accrued benefit obligation is an obligation of the employer.

Question 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 reports(s) should contain that presentation: the employer's, the plan's or both? Why?
- b. If yes, should the presentation be basic financial statement, a note to the basic financial statements, or required supplementary information? Why?

The changes in the unfunded accrued benefit obligation should be provided as required supplementary information. Fluctuations in unfunded obligations can have a significant impact on the plan's funded status and contribution rates. A disclosure of the cause or causes in unfunded liability fluctuations would help the reader more easily understand the dynamics behind the changes in the plan's financial health. The current method of providing this information in the notes is not always consolidated or fully detailed.

We support the GASB's interest in revisiting the pension accounting and reporting standards and thank you for the opportunity to provide input.

Sincerely,

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