

September 17, 2010

Director of Research and Technical Activities – Project No. 34  
Governmental Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

**SUBJECT: RESPONSE TO PRELIMINARY VIEWS OF THE GASB ON MAJOR ISSUES RELATED TO PENSION ACCOUNTING AND FINANCIAL REPORTING BY EMPLOYERS**

The Virginia Government Finance Officers Association (VGFOA) would like to take this opportunity to respond to your Preliminary Views (PV) document on, “Pension Accounting and Financial Reporting by Employers”. Below, please find our responses to the questions posed in the PV document, as well as some additional comments that follow. The VGFOA appreciates the opportunity to work with the Governmental Accounting Standards Board (GASB) in the development of improved financial reporting standards.

**Issue 1—An Employer’s Obligation to Its Employees for Defined Pension Benefits**

1. *It is the Board’s preliminary view that, for accounting and financial reporting purposes, an employer is primarily responsible for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits. (See Chapter 2, paragraphs 5–10.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

The VGFOA believes that the answer to this question depends upon the situation of the specific employer, as well as the nature of the plan and the terms of the plan agreement. For example, if an employer sponsors a sole-employer plan, there is no doubt that the employer is primarily responsible for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits, even if the benefits are to be paid out of a separate entity, such as a pension trust.

However, the VGFOA believes that employers participating in agent multiple employer defined benefit pension plans may not be primarily responsible for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits, depending upon the nature of the plan and the terms of the plan agreement.

In either case, the VGFOA believes that the main factor in determining the primary responsibility for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits is rooted in the concept of financial accountability.

A recent Exposure Draft of the GASB (Project No. 3-14) asserted that financial accountability exists where a primary government “appoints a voting majority of an organization’s governing body *and* (1) it is able to impose its will on that organization *or* (2) there is a potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the primary government.” Additionally, the Exposure Draft stated that in the absence of criteria related to the imposition of will, financial accountability could also be established “...if an organization is fiscally dependent on...the primary government”.

The GASB states in its Preliminary Views document that an employer’s obligation resulting from the employment exchange “...is not satisfied until the defined pension benefits have been paid to the employees or their beneficiaries when due.” This is certainly an accurate statement in the context of a sole-employer pension plan. In that situation, an employee has a reasonable expectation of receiving the benefits as promised in the employment exchange, and in the case of an underfunded plan, even though the legal obligation to provide pension benefits falls to the pension trust, the VGFOA believes that the sole-employer has an obligation to supplement the plan net assets available for benefits to the extent that they fall short, to ensure that these obligations are properly met. This responsibility is emphasized through the concept of financial accountability. In most cases the primary government has substantial influence over the governing body of the pension trust through its appointment of, at a minimum, a voting majority of its members. In addition, it can be established that the trust is fiscally dependent on the primary government, and there is certainly the potential for the pension trust to impose specific financial burdens on the primary government. Therefore, in all respects, the primary government is financially accountable for the pension trust, and therefore, retains the primary responsibility for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits.

However, there is far less certainty of such an obligation to the employer in the case of an agent multiple employer pension plan. In this case, the VGFOA believes that the primary responsibility for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits should rest with the entity which retains financial accountability over the pension trust, which in many cases, is not the individual employers who contribute to the plan on behalf of their employees.

In Virginia, a large number of political sub-divisions participate in the Virginia Retirement System (VRS), which operates, among other plans, an agent multiple employer pension plan. These employers, upon remitting the required contributions to the pension trust (as calculated by VRS), relinquish complete control over the assets to VRS management. VRS Board members are appointed by either the Governor or a committee of the legislature, and not by the primary governments participating in the plan. Additionally, member jurisdictions participating with VRS have minimal or no influence in decisions made which affect the plan’s funding status, such as contribution rates, investment decisions, and even future COLA percentages. Therefore, these primary governments neither appoint a voting majority of VRS’ governing body, nor do

they have the ability to impose their will. Additionally, VRS has no fiscal dependency on any individual county, city, or special purpose government of the Commonwealth of Virginia which participates in the pension plan. Therefore, these participants in VRS are not financially accountable for the plan, and therefore, should **not** be viewed as primarily responsible for the portion of the obligation for defined pension benefits in excess of the plan net assets available for benefits. Instead, based upon the principle of financial accountability, primary responsibility would more appropriately fall to the Commonwealth of Virginia.

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

*2a. It is the Board’s preliminary view that the unfunded portion of a sole or agent employer’s pension obligation to its employees meets the definition of a liability (referred to as an employer’s net pension liability). (See Chapter 3, paragraphs 1–8.) Do you agree with this view? Why or why not?*

### **VGFOA Response:**

The VGFOA believes that to some degree, the GASB may be asking the wrong question here. It seems that there would be very little debate as to whether the unfunded portion of a pension obligation meets the definition of a liability, rather, the more pertinent question is, to whom does the unfunded portion of a pension obligation represent a liability?

As alluded to in our response to Question 1, the VGFOA believes that employers sponsoring sole-employer pension plans are financially accountable for those plans, and therefore, retain the primary responsibility for their funding. Therefore, if such a plan were partially unfunded, the employer would themselves incur a liability.

Similarly, an agent multiple employer pension plan that is partially unfunded presents a scenario wherein a liability could exist. However, unlike the sole-employer pension plan, it cannot be concluded that this situation represents a liability to any individual participant in the agent multiple employer pension plan, absent a demonstration that the individual participant is financially accountable for the plan.

One of the main factors in a primary government’s decision to participate in an agent multiple employer pension plan (such as the VRS plan described in our response to Question 1) is the desire to transfer certain risks to a third-party, rather than retaining those risks, and creating a sole-employer pension plan. Among the risks transferred are actuarial risk, investment risk, and management risk. In doing so, a participating government relinquishes control over the assets associated with the plan, and also surrenders all decision-making and management authority over the pension plan to another organization. This decision is not unlike a decision to acquire an insurance policy.

For example, if a primary government decides to acquire a general liability insurance policy with an external vendor/organization rather than to self-insure (e.g. creating a

self-insurance internal service fund), its intention is to transfer that portion of their overall risk to a third-party rather than retaining and managing the risk themselves. The primary government surrenders control over certain agreed-upon assets through rate charges determined by the external vendor/organization, and relinquishes its decision-making authority over those assets/investments. If the insurer, through a combination of poor investment choices, excessive spending, improper management, and/or higher than anticipated claims encounters a situation wherein obligations to policy holders are partially underfunded, would there be any suggestion that the policy holders record a liability for the unfunded portion of those obligations?

Additionally, if the individual participating governments in an agent multiple employer pension plan were to be deemed primarily responsible, and as such, under compulsion to present a liability for a partially unfunded plan, this would serve to understate the liabilities of the entity that is ultimately financially accountable for the management of the plan.

Therefore, while the VGFOA does agree that the unfunded portion of a pension obligation meets the definition of a liability, we do not believe that this liability should always be attributable directly to the employer.

*2b. It is the Board's preliminary view that the net pension liability is measurable with sufficient reliability to be recognized in the employer's basic financial statements. (See Chapter 3, paragraphs 9–13.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

The VGFOA agrees that the net pension liability may be measurable with sufficient reliability to be recognized, depending on what components are includable as part of the calculation (see our response to Question 3a); however, consistent with our answers to Questions 1 and 2a, we do not necessarily agree that this liability should always be recognized in the employer's basic financial statements, specifically as it pertains to agent multiple employer pension plans.

The VGFOA also believes that there may be instances where a previously estimated net pension liability has decreased, been completely extinguished, or even converted into a net pension asset; again however, we do not agree that the net pension asset should always be recognized in the employer's basic financial statements.

However, the VGFOA believes that the current practice of focusing on the Annual Required Contribution (ARC) and any Net Pension Obligation (NPO) is more appropriate for several reasons. First, as discussed in more detail in our "Other Comments", the VGFOA believes that a by-product of changing focus would either be delays in financial statement publication and audit opinions, or the inclusion of liabilities measured as of the prior year financial statement date with liabilities measured as of current year financial statement date. Second, this change in focus has the potential to make employers who are not fully funding their ARC look good in years where the market

performs well, while making employers who have fully funded the ARC look bad when the market performs poorly.

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

*3a. It is the Board's preliminary view that the projection of pension benefit payments for purposes of calculating the total pension liability and the service-cost component of pension expense should include the projected effects of the following when relevant to the amounts of benefit payments: (1) automatic cost-of-living adjustments (COLAs), (2) future ad hoc COLAs in circumstances in which such COLAs are not substantively different from automatic COLAs (see also question 3b), (3) future salary increases, and (4) future service credits. (See Chapter 4, paragraphs 4–13.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

The VGFOA does not believe that it would be appropriate to include the projected effects of COLA's, future salary increases, and future service credits in the determination of the carrying amount of the pension liability for a few reasons.

First, the VGFOA believes that the projected effects of these future transactions is congruent with the concept of a contingent liability, which must be both "probable" and "reasonably estimable" before being included on the balance sheet. In the case of ad hoc COLA's, future salary increases, and future service credits, there are too many contingencies that must be satisfied in order to conclude that any of these projected increases is "probable" under the definition of a contingent liability. For example, future salary increases would be contingent upon, among other factors:

1. Continued employment;
2. Satisfactory performance so as to warrant a salary increase;
3. Economic and budgetary conditions conducive to awarding salary increases;

Even the contingencies noted above have contingencies. For example, the contingency of continued employment depends on a variety of factors that is impossible to predict over the course of an employee's tenure.

Not only this, but to conclude that the probabilities associated with these contingencies are equal across all classes of employees is unreasonable. Public safety employees have vastly different demographics than custodial staff, for example. The expectations for the future employment status of teaching staff would be far different from those of a landfill scale operator. These factors have obvious implications on the overall probability of the liability, but also render them nearly impossible to "reasonably estimate". GASB Concept Statement No. 3 indicates that an item must be "measurable with sufficient reliability" to be recognized in the financial statements. Therefore, being neither "probable" nor "reasonably estimable", the VGFOA does not believe these

projections should be included as part of a pension liability on the face of the financial statements.

Second, there are other balance sheet items that are similar in nature to the total pension liability that would be valued inconsistently if these projections were to be required for the pension liability. For example, in theory, the compensated absences liability would be affected by many of the same factors identified by the GASB as pertinent to the total pension liability. Both represent a promise to provide a future benefit that is directly tied to the amount of an employee's salary. If an argument can be made that the effects of COLA's, future salary increases, and future service credits should be considered in determining the total pension liability, how would that same argument not apply to the compensated absences liability? Shouldn't these ostensibly similar balance sheet items be measured and recognized in a consistent manner and basis?

Third, the VGFOA believes that, to the extent possible, the total pension liability and total pension assets should utilize the same basis and methods of measurement so as to render them comparable, since the cost of pension benefits is reduced by earnings on the related investments. In fact, some of the future events that the GASB cites as having a potential impact on the "ultimate amount of pension benefit payments" would also have an impact on the ultimate amount of pension assets available to meet those obligations. For example, future COLA's and salary increases would normally result in increased contributions to the pension plan, since those contributions are typically based upon the salaries of the employees. If the probability-weighted expectations about the projected effects of these factors are to be considered in determining the value of the total pension liability, shouldn't they also be used to determine the value of the assets and investments available to meet those future obligations? So, while we agree with the GASB that the inclusion of such factors on the liability side is certainly a more conservative approach, we are concerned that significant differences between the basis of measurement of plan assets and plan liabilities would lead to misconceptions related to the funding status of the pension plan.

The VGFOA would like to suggest an alternative approach, wherein the effects of COLA's, future salary increases, and future service credits on the total pension liability could be presented in the footnotes of the pension plan financial statements, as well as discussion as to how the related pension assets would be affected by those same factors as applicable.

*3b. What criteria, if any, do you suggest as a potential basis for determining whether ad hoc COLAs are not substantively different from an automatic COLA and, accordingly, should be included in the projection of pension benefit payments for accounting purposes?*

**VGFOA Response:**

The VGFOA does not believe that future ad hoc COLAs should be included in the projection of benefit payments for accounting and financial reporting purposes, since the decision of whether or not to award such COLAs hinges on too many unknown

factors to accurately predict. Even when there may be a demonstrated pattern of highly predictable ad hoc COLAs, it only takes a change to one of these important variables (e.g. turnover on the governing body, downward economic trends, etc.) to significantly alter that pattern for the foreseeable future.

- 3c. *It is the Board’s preliminary view that the discount rate for accounting and financial reporting purposes should be a single rate that produces a present value of total projected benefit payments equivalent to that obtained by discounting projected benefit payments using (1) the long-term expected rate of return on plan investments to the extent that current and expected future plan net assets available for pension benefits are projected to be sufficient to make benefit payments and (2) a high-quality municipal bond index rate for those payments that are projected to be made beyond the point at which plan net assets available for pension benefits are projected to be fully depleted. (See Chapter 4, paragraphs 14–23.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

Where discounting is appropriate, the VGFOA agrees in general with the approach presented by the GASB, most specifically the single-rate approach, which allows for ease of application and calculation. However, there is some concern that the municipal bond index rate is generally a composite rate that often includes debt that is not relevant to this calculation. Also, the current year new issuance municipal bond index rate may be different than the rate used at a future projected point in time. Therefore, the VGFOA would ask that the GASB include expanded discussion on the applicable rate for payments projected to be made beyond the point when plan net assets available for pension benefits are projected to be fully depleted.

- 3d. *It is the Board’s preliminary view that for purposes of determining the total pension liability of a sole or agent employer, as well as the service-cost component of pension expense, the present value of projected benefit payments should be attributed to financial reporting periods over each employee’s projected service life using a single method—the entry age actuarial cost method applied on a level-percentage-of-payroll basis. (See Chapter 4, paragraphs 24–34, and Chapter 5, paragraphs 6 and 7.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

While the VGFOA would prefer that GASB permit the use of any method allowed by actuaries to attribute the present value of projected benefit payments to financial reporting periods over each employee’s projected service life, if the GASB decides to move forward with the single method approach, the VGFOA believes that the use of the entry age actuarial cost method is consistent with the provisions of GASB Statement No. 50, and thus, appears reasonable for these purposes as well.

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

*4a. It is the Board’s preliminary view that the effects on the net pension liability of changes in the total pension liability resulting from (1) differences between expected and actual experience with regard to economic and demographic factors affecting measurement, (2) changes of assumptions regarding the future behavior of those factors, and (3) changes of plan terms affecting measurement should be recognized as components of pension expense over weighted-average periods representative of the expected remaining service lives of individual employees, considering separately (a) the aggregate effect on the liabilities of active employees to which the change applies and (b) the aggregate effect on the liabilities of inactive employees. (See Chapter 5, paragraphs 8–10.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

The VGFOA agrees with the GASB’s preliminary view that various transactions and events affect the net pension liability applicable to active employees differently than the liabilities applicable to inactive employees. Therefore to improve consistent disclosure, we believe that pension plan financial statements should separately consider the effect these various factors have on the pension liability for each group of employees.

*4b. It is the Board’s preliminary view that the effects on the net pension liability of projected earnings on plan investments, calculated using the long-term expected rate of return, should be included in the determination of pension expense in the period in which the earnings are projected to occur. Earnings on plan investments below or above the projected earnings should be reported as deferred outflows (inflows) unless cumulative net deferred outflows (inflows) resulting from such differences are more than 15 percent of the fair value of plan investments, in which case the amount of cumulative deferred outflows (inflows) that is greater than 15 percent of plan investments should be recognized as an increase or decrease in expense immediately. (See Chapter 5, paragraphs 12–15.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

The VGFOA agrees with the GASB’s concept in the preliminary view on the method to determine the amount of the net pension liability to incorporate into the calculation of annual pension expense; however, we are confused about the specific application. The VGFOA requests clarification as to whether the investment rate of return used in this calculation is the same as the rate discussed in Issue 3c. We cannot determine whether these two rates are related or not. We recommend the GASB include expanded discussion and examples to ensure consistent and correct application.

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

*5a. It is the Board’s preliminary view that each employer in a cost-sharing plan is implicitly primarily responsible for (and should recognize as its net pension liability) its*

*proportionate share of the collective unfunded pension obligation, as well as its proportionate share of the effects of changes in the collective unfunded pension obligation. (See Chapter 6.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

As stated previously in our response to the GASB, the VGFOA believes that the primary responsibility question should be addressed through the lens of financial accountability. To the extent that cost-sharing plans differ from agent multiple employer plans, those variations are likely to result in disparate outcomes to the question of primary responsibility. In the event that multiple jurisdictions can be shown to be financially accountable for the cost-sharing plan, each jurisdiction should recognize its proportionate share of the collective unfunded pension obligation, as well as its proportionate share of the effects of changes in the collective unfunded pension obligation. However, as described in more detail in our “Other Comments”, the VGFOA has some significant concerns related to how a jurisdiction’s ability to meet certain financial reporting deadlines would be adversely affected by this type of requirement, and again, believes the current approach of focusing attention on the ARC and NPO is more appropriate and useful to financial statement users.

*5b. The Board is considering basing the determination of proportionate shares of the collective net pension obligation on employers’ respective shares of the total annual contractually required contributions to the plan and believes that would provide a reliable basis for measurement. However, the Board is seeking constituent input regarding other potential bases that might exist for this determination. (See Chapter 6, paragraph 8.) What basis, if any, do you suggest for determining a cost-sharing employer’s proportionate share of the collective net pension obligation?*

**VGFOA Response:**

The VGFOA believes that in instances where it would be appropriate to allocate proportionate shares of the collective net pension obligation to each participating employer, basing that allocation on the employers’ respective shares of the total annual contractually required contributions seems reasonable and rational under normal circumstances; however, as noted in our additional comments, we note that there may be instances where this may not yield the most reliable results.

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

*6. The Board’s preliminary view is that a comprehensive measurement (an actuarial valuation for accounting and financial reporting purposes) should be made at least biennially, as of a date not more than 24 months prior to an employer’s fiscal year-end. If the comprehensive measurement is not made as of the employer’s fiscal year-end, the most recent comprehensive measurement should be updated to that date. Professional judgment should be applied to determine the procedures necessary to reflect the effects of significant changes from the most recent comprehensive measurement date to the employer’s fiscal year-end. Determination of the procedures needed in the particular*

*facts and circumstances should include consideration of whether a new comprehensive measurement should be made. (See Chapter 7.) Do you agree with this view? Why or why not?*

**VGFOA Response:**

The VGFOA believes that in general, biennial actuarial valuations are sufficient; however, because various primary governments participating in a cost-sharing plan, for example, may have differing fiscal years, it may be possible that a primary government may encounter a situation wherein the date of the most recent actuarial valuation available at the time of financial statement preparation exceeds 24 months prior to the employer's fiscal year-end. We recommend that the GASB focus its requirements on the frequency of required actuarial valuation from the perspective of the fiscal year of the pension plan, rather than on the age of the valuations in comparison with the financial statement date of the participating employers, so long as it can be demonstrated that the employers used the most recent data available at the time of financial statement issuance.

**Other Comments**

In addition to the questions you have raised in the Preliminary Views document, the VGFOA has other comments and concerns related to the issue of pension accounting and financial reporting by employers, specifically as they relate to agent multiple employer and cost sharing pension plans.

First, the VGFOA is concerned that where cost-sharing multiple employer pension plans are concerned, the GASB seems to be operating under the presumption that all participants in such plans are essentially one homogenous pool. In reality, there are many distinctions between the various jurisdictions that participate in a single plan that would place a tremendous burden on the retirement system if they were required to allocate a net pension liability among its member jurisdictions on any meaningful basis. For example, some members of the system may fully fund their Annually Required Contribution (ARC), while others only partially fund the ARC. For some participating jurisdictions, this funding disparity exists occasionally on a one-time basis, while for others, it may be perpetual. Further, some participating jurisdictions could be granted a contribution holiday to help cover budget gaps, with payment ultimately deferred to a future fiscal year. This deferral however, may not be available for other participating jurisdictions; rather, those jurisdictions would contribute as they always have. All of these factors could have a profound impact on the overall funding status of the retirement system, especially as they exist over numbers of years. However, if allocation were to occur via some method related to the proportionate share of the ARC for example, it could result in a situation wherein some jurisdictions would be forced to carry a net pension liability that was actually created by another jurisdiction's funding decisions.

Second, if any proposed guidance were to follow the views as outlined by the GASB in its Preliminary Views document, the VGFOA is concerned that, because the funding status of pension plans can oscillate from year to year due to fluctuations in any number of factors, it could create a situation wherein jurisdictions participating in a pension plan would be unable to

complete their own financial statements until after the audited financial statements of the pension plan are completed. This could cause serious problems throughout the public sector with certain compliance and reporting standards commonly faced by state and local governments.

For example, jurisdictions participating in an agent multiple employer pension plan could be forced to delay the final release of their financial statements, and certainly independent external auditors would delay the release of an opinion on those financial statements, until a determination on the funding status of the pension plan, and the final amount of the total net pension liability (if any) could be calculated. Furthermore, once a total net pension liability is determined, it would have to be allocated to all of the participating jurisdictions, which could cause additional delays.

Third, as it relates to agent multiple employer pension plans, there is some question as to whether a pension liability from underfunding could exist, from a legal perspective, depending on the structure and terms of the pension agreement, so long as the participating jurisdictions have fully funded the annually required contribution. For example, many agent multiple employer pension plans contain provisions which indemnify the retirement system from any liability for losses suffered by members of the system, so long as there has been no breach of the standard of care by the system's management. From an individual jurisdiction's perspective, it is difficult to imagine a legal liability to a retiree, since a successful legal claim must normally prove that the defendant did something wrong or illegal (a breach) to cause the plaintiff some harm. As long as the participating jurisdictions can show that the ARC has consistently been fully funded, it would appear difficult to prove that any harm or damages could have been caused by their actions.

Due to these factors, the VGFOA is not convinced that many of the provisions discussed in the Preliminary Views document would be applicable to agent multiple employer pension plans in the same way they would apply to sole employer or cost sharing plans, and would request that the GASB consider this in its continued deliberations.

On behalf of the VGFOA, I would like to thank you in advance for considering our suggestions and look forward to working with the GASB in the future toward improving the standards for our industry. If you have any questions or comments concerning this response, please feel free to contact me either by phone at (540) 853-2821, or at [ann.shawver@roanokeva.gov](mailto:ann.shawver@roanokeva.gov).

Sincerely,



Ann H. Shawver  
President, Virginia Government Finance Officers' Association and  
Director of Finance, City of Roanoke, Virginia  
215 Church Avenue SW, Room 461  
Roanoke, VA 24011