



# Cavanaugh Macdonald

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October 6, 2011

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

To the Director of Research and Technical Activities:

Cavanaugh Macdonald Consulting, LLC (CMC) thanks the Governmental Accounting Standards Board (GASB) for this opportunity to comment on the Exposure Drafts (EDs) for the proposed amendments to GASB Statement No.25 (*Financial Reporting for Pension Plans*) and Statement No. 27 (*Pension Accounting and Financial Reporting by Employers*). As a leader in providing actuarial consulting services to state and local government pension plans, we have been engaged with various actuarial organizations in the discussions regarding specific technical issues with the EDs. We are satisfied that the comments to be made by those organizations will provide GASB the detailed concerns of the actuarial professionals serving public pension plans. We therefore focus our firm's comments on a broader perspective of the proposed amendments and discuss the implications of the EDs on the public pension environment.

GASB's proposed amendments have a stated goal of improving the "*transparency of financial reporting*" and "*the usefulness of information for decisions or judgments of relevance....*" This would imply that the current reporting by government employers and pension plans is not sufficiently transparent and that some information for making decisions is lacking. Since the current reporting is based upon the actuarial valuation results for the applicable reporting period, this gives the impression that there is at best something wanting in the actuary's development of required funding or, at worst, the valuation results provide misleading information for the purpose of decision making.

GASB has acknowledged that there are many complex and technical issues surrounding retirement plans, as evidenced by its preparation of a less technical Plain Language Supplement to the ED's. GASB states, "*This supplement is prepared for citizens, taxpayers, elected representatives, municipal analysts, and other external users of governmental financial information and contains a minimum of technical terminology.*" If GASB perceives, for those who may have limited technical understanding, that such a supplement is necessary to simply describe how the accounting standards are proposed to be changed, should there be concern that

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the proposed standards themselves may be too complex and unwieldy? The proposed standards appear to assume that all decision makers who view the resulting financial reporting under the proposed amendments will not misinterpret the information. Our concern is that the ED's reduce the complexities of funding a long term pension system to two numbers in the financial statements, an expense and a Net Pension Liability, which will almost certainly be at odds with the actuarial valuation work produced by the system's retained actuary. While there is additional information provided, the non-technical users may be inclined to simply latch on to these two numbers, resulting in misunderstanding rather than clarity. We think the assumption that decision makers viewing the financial statements will not misinterpret the information is short-sighted at best and will lead to obfuscation rather than transparency at worst.

GASB may be too concerned about only limited segments of decision makers that may benefit from having the pension liability and expense reported on the face of the financial statements - for instance, the rating agencies. In reality, the rating agencies utilize experts who are quite familiar with the current reporting standards and are adept at reviewing the required supplementary information, as well as other related information, in the course of performing their task. In contrast, there are many other decision makers who will draw the conclusion that results reported so prominently in financial statements must be the most accurate measure of the liability and expense related to pension benefits. These decision makers will often not be as familiar with financial reporting nor will they look further into the required supplementary information. In addition, many decision makers will not understand the technical differences between the actuarial results for funding and the measures proposed by GASB in the amended statements. This may lead them to view the actuarial valuation results, since they are not used as the basis for financial reporting, as a less credible measure of the pension liability and required funding.

GASB states in the Overview section of the Plain Language Supplement, *“The proposals would separate how the accounting and financial reporting is determined from how pensions are funded. Should the proposals become accounting and financial reporting standards in the future, governments would not be required to mirror the accounting and financial reporting changes in their funding approaches.”* The wording implies that although governments would not be required to fund the plan based upon the accounting measures, it may be a reasonable approach. Such wording may mislead employers, causing a change to a dramatically more volatile funding approach when in fact neither the current “funding friendly” nor prior standards **required** the employer to fund based upon the accounting measures. By stating that “governments would not be required” to fund their pensions based upon the accounting expense, GASB does not clearly distinguish that the accounting measures should not to be considered as a basis for funding or benefit decisions. In fact, it would be nearly impossible for an employer to attempt to fund a plan on the basis of the proposed accounting standards, particularly since these standards would allow for years with negative expense, and it would be illegal for an employer to remove money from the plan so as to keep funding and accounting on the same basis.

We find it difficult to believe that GASB does not understand the influence its positions and statements have within the pension community, and, specifically, the governmental departments and other decision making bodies which are tasked with funding and benefit oversight. One only



need look back to the findings supported by GASB in formulating the current Statements Nos. 25 and 27. The following excerpts are from paragraph 59 of Statement No. 27 concerning the review of the experiences with the accounting measures required under Statement No. 5, the precursor to Statements Nos. 25 and 27. Statement No. 5 also provided accounting measures on a different basis than the basis for funding (Note - the PBO – Pension Benefit Obligation was the standardized measure of the plan’s accrued benefit liability):

*“A major concern of many respondents was that the PBO has been **used**, but not for the purpose for which it was intended. Rather, it has been used primarily to justify reducing employers’ contributions.”* ; and

*“As a result, legislatures have been pressured to reduce employer contributions or increase benefits without increasing contributions, and some of those efforts have been successful.”* ; and

*“all that had occurred was a deferral of costs to the future and a disruption of an orderly funding process.”*; and finally

*“as a result, legislators, public officials, and others interpret the required disclosure to mean that plans **should be funded** using...”* the GASB required methodology *“and that the GASB prefers that approach.”*

Apparently the Board now believes that in a future year when the calculation of pension expense under the proposed amendments is significantly less than the actuarially calculated contribution (e.g., a well funded plan with significantly better than expected investment returns), the same pressures, same misuses, and same misinterpretations won’t occur under the proposed statements.

We further question the dramatic shift in GASB’s beliefs concerning the impact that accounting requirements have on the funding of pensions. In the proposed changes GASB has communicated their belief that accounting measures do not necessarily impact funding. However, it was very apparent that the Board considering the implementation of the current statements believed otherwise as discussed in paragraph 73 of GASB Statement No.27 , *“The Board believes that it would be confusing and potentially misleading for legislators, public officials, and others who make decisions about benefit levels and contribution rates to provide accounting measures of pension information that differ from those produced by the funding methodology.”* In our view, the public pension environment has not changed to the extent necessary to expect that these decision makers will not now be confused or potentially misled under GASB’s proposed dramatic changes to accounting and financial reporting for pensions.

We suggest GASB make clear in introducing any change in the direction of the proposed amendments that the measures required for accounting and financial reporting are not now and have never been required to be considered in making decisions concerning the actual funding of pensions nor for basing judgments on the actuarial condition of the pension plan. Further, we suggest that GASB also clearly communicate (in the form of a paragraph in the amended statement) that any decision regarding a plan’s funding or benefits should be based solely on the work performed by the qualified actuaries engaged by the plan administrator and approved by



the plan's governing body. We recommend that GASB require that similar language be included with the accounting disclosures to notify all users that the information is not reliable for the purpose of basing decisions concerning actual plan funding or appropriate levels of benefits, and should not be the basis for making judgments concerning the true actuarial condition of the pension plan. Being able to reference such statements will go a long way toward focusing any future discussions regarding plan funding where it belongs – on the work of the plan's actuary and not the required accounting disclosures.

We have stated our preference that accounting and funding not be separated in our prior responses to GASB requests for information during this pension project. We believe that GASB is focused too narrowly on a concept for accounting to the point that it ignores the serious implications that the proposed statements will have on the governmental pension environment. We ask GASB to consider the following three questions: How does reporting plan liabilities and determining pension expense on a basis different than calculated for the purpose of funding the pension improve transparency? Which specific decision makers will find the information provided under the proposed statements more useful? Is the risk of the potential misinterpretations, misuses, and confusion along with the additional expense and effort to provide the required information really more than offset by any perceived improvement? In our opinion it would have to be a significant improvement, and we do not believe the proposed changes accomplish that goal.

In closing, we thank GASB for this opportunity to comment on the EDs. If you have questions regarding this letter, please do not hesitate to contact us.

Sincerely,

A handwritten signature in blue ink that reads 'Thomas J. Cavanaugh'.

Thomas J. Cavanaugh, FSA, FCA, MAAA, EA  
Chief Executive Officer