CITY OF FORT LAUDERDALE

OFFICE OF THE CITY AUDITOR

Government Accounting Standards Board (GASB)
Preliminary Views on major issues related to Pension Accounting
and Financial Reporting by Employers

Report #09/10-07

September 16, 2010

CITY OF
FORT LAUDERDALE

City Auditor's Office

Memorandum

No: 09/10-11

Date: September 16, 2010

To: Mayor John P. "Jack" Seiler
Vice-Mayor Bruce G. Roberts
Commissioner Charlotte E. Rodstrom
Commissioner Bobby B. DuBose
Commissioner Romney Rogers

From: John Herbst, CPA, CGFO
City Auditor

Re: Government Accounting Standards Board (GASB) Preliminary Views on major issues related to Pension Accounting and Financial Reporting by Employers

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The City Commission requested input from the City Auditor's Office regarding the solicitation by GASB for input by users and preparers of financial statements for governmental entities on major issues related to Pension Accounting and Financial Reporting by Employers.

GASB began a research project in 2006 to evaluate the accounting standards used by governments for reporting of pension benefits and liabilities. In 2009, they solicited comments regarding issues identified in their research. Based on their research, and the 120 comments received, GASB developed the Preliminary View. GASB is presently seeking additional comments prior to issuing an Exposure Draft of the new standard.

The issues identified by GASB are as follows:

- The Nature of a Government's Pension Obligation
- Measuring a Government's Total Pension Liability
- Reporting Changes in a Government's Net Pension Liability
- The Timing and Frequency of Pension Measurements

My responses to the issues and questions posed by GASB are outlined below. It is foreseeable that additional scrutiny of the true costs of pensions may lead to the eventual modification or elimination of defined benefit pension plans in the future. My responses deal strictly with what I deem to be the appropriate accounting treatment and do not consider the potential impact these changes may have on the City's pension plans over time.

QUESTIONS FOR RESPONDENTS

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?

RESPONSE
Agree. The employer has a contractual and legal obligation to fund any shortfall in the pension plans.

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?

RESPONSE
Agree. The pension obligation: (a) embodies a present responsibility to employees as compensation in exchange for labor, that entails settlement by future transfer or use of assets at determinable date, on occurrence of a specified event (retirement), (b) the responsibility obligates the employer, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction obligating the entity has already happened.

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?

RESPONSE
Agree. Employers may reasonably estimate the net pension liability using accepted actuarial methods and assumptions . Liabilities that are measurable and certain should be reported as a component of the financial statements, not as footnote disclosures.

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?

RESPONSE
Agree. Estimates of automatic, or near-automatic COLAs, future salary increases, and future service credits can be reasonable determined and easily incorporated into the calculation of the future liabilities

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?

RESPONSE
I would suggest looking at the frequency at which ad-hoc COLAs were awarded over the prior 10 years, with a threshold of 75% indicating that ad-hoc COLAs are not substantively different from automatic COLAs.

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?

RESPONSE
Agree. (1) The future liability will be reduced by the available future value of the plan's net assets, which can be expected to grow at the actuarially assumed rate of return. (2) To the extent that a portion of the future liability remains unfunded, the appropriate discount rate should be a reflection of the employer's cost of capital (i.e. the municipal bond index).

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?

RESPONSE
No comment.

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?

RESPONSE
Agree. The pension liability arises out of an exchange transaction with the employee for current and future services. Any changes in the net pension liability should be amortized of the remaining duration of the services to be provided.

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?

RESPONSE
Disagree. Prudent investing over long periods of time assumes a fair amount of volatility above and below the actuarially assumed rate of return. Those amounts should remain as deferred outflows (inflows) until such time as actual returns revert to the mean, which should be the plan's assumed rate of return. If not, the assumed rate of return may have to be adjusted.

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?

RESPONSE
No comment.

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?

RESPONSE
No comment.

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?

RESPONSE
I agree that an actuarial valuation needs to be done at least biennially in order to insure that assumptions remain valid and that significant differences don't arise between prior assumptions and actual experience.