



Federal Accounting Standards Advisory Board

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March 8, 2007

TO: Members of FASAB

FROM: Richard Fontenrose, Assistant Director

THROUGH: Wendy Comes, Executive Director

SUBJECT: Standard re Reporting Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates – Tab F<sup>1</sup>

The minutes of the January FASAB meeting, which are included in the March briefing book, contain the staff's summary of the Board's decisions about the proposed statement "Reporting Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates."

This memorandum discusses activity since the January meeting. The first section below discusses comments received from agencies; in the next section, the staff discusses its recommendations based on comments received; and the last section discusses other activity resulting from the January meeting.

A key activity since the January meeting has been to vet the standards with the affected agencies, although there were several other issues to develop as well. The updated exposure draft (ED), with changes tracked, is at Tab F-1 for the members' reference. The objective of this session is to review the agencies comments and staff recommendations, make changes as the members may direct, and decide whether to proceed to a pre-ballot draft of the proposed standard.

### ***I. Vetting the Statement with Agencies***

As indicated on the project schedule presented at the January FASAB meeting, staff asked agencies to comment on the display, discount rate, and valuation date standards. The following agencies commented:

- Office of Personnel Management (OPM), Office of the Chief Financial Officer (OCFO) and Office of the Actuary;
- Department of Defense (DoD), Office of the Actuary;

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<sup>1</sup> The staff prepares Board meeting materials to facilitate discussion of issues at Board meetings. This material is for discussion purposes only; it is not intended to reflect the authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

- Social Security Administration (SSA), OCFO;
- Department of Health and Human Services (HHS), OCFO;
- HHS, Center for Medicare and Medicaid Services (CMS), Office of Financial Management, Accounting Management Group; and,
- A private actuary commenting as an individual. The actuary is currently working with professional actuarial associations to resolve issues with respect to, for example, insurance accounting, and is consulting with the Federal agencies on actuarial issues, especially with Department of Veterans' Affairs. He has commented on prior drafts of the ED.

The agency commentors did not object to any aspects of the display and valuation date standards, except for HHS representatives as noted below. Many comments focused on the discount rate standard.

### ***Display Standard***

The OPM and the DoD, Office of the Actuary, commented that the display and valuation date standards do not present a problem. Likewise, the Social Security Administration (SSA), OCFO, did not object to the display and valuation date standards.

On the other hand, the HHS/OCFO, and the Accounting Management Group, Office of Financial Management, CMS, commented that footnote disclosure is adequate and a line item on the statement of net cost (SNC) is unnecessary. The HHS/OCFO, commented that a footnote would provide complete detail and avoid the confusion of separate line items on the face of the statement.

### ***Discount Rate Standard***

The primary area of concern for the Board and staff has been the discount rate provisions. Regarding that proposed standard, the OPM actuary commented that they prefer a single discount rate. They essentially combine the discount rate and the rate of inflation and apply the resulting "real" interest rate. They keep the discount rate constant for five years.

The discount rate standard as proposed in the January draft ED would have required multiple discount rates associated with each future year in which payments are due. The rationale for the proposal is essentially that individual rates would more accurately reflect the time value of money.

The OPM actuary believes that for Federal plans a single rate is the only practical method for the discount rate. He asserted that calculating rates for each of the 70+ years in the future for which benefit payments are scheduled would be very complex. Use of a single rate would be simpler and has administrative advantages for OPM. The OPM is the Governmentwide administrator for Federal civilian employee retirement benefits.

The DoD Office of the Actuary also commented that they prefer a single rate.

On the other hand, the actuary consulting with the VA and with other Federal agencies commented that he preferred not to use a single discount rate, although he did not object to it. He said multiple discount rates had been in use for VA programs for decades, and he does not think discount rate calculations are particularly complex. Considering the prevalence of high-speed computers, he said he would opt for the appropriate accounting principle over “simplicity” of application. He noted that a single average interest rate would still require re-calculation at each reporting period for comparison with the existing rate to determine if a change was warranted. Barring unusual circumstances, the difference from year to year for a discount rate based on long-term, historical Treasury rates would be small and perhaps even off-setting; but the entity would be expected to demonstrate that the effect is immaterial.

He also objected to having a fixed time period in the standard for keeping discount rates constant. He commented that any fixed period would be arbitrary. He recommended a principled approach, and he noted that the discount rate should remain the same for as long as economic expectations remain the same; time restrictions would be artificial.

In addition, he noted that, fundamentally, the ED approach that emphasizes Treasury rates rather than plan assets is appropriate over the long-term.

The DoD Office of the Actuary commented that the discount rate standard should be clearer about the need to exercise judgment. They said that the DoD Retirement Board of Actuaries relies heavily on the history of the Military Retirement Fund’s (MRF) experience in determining long-term economic assumptions and is careful not to weight recent experience heavily; but it is not an exact science.

The HHS/OCFO concurred with the discount rate standard as written.

### **Valuation Date Standard**

The only commentor who objected to the valuation date standard was the HHS/OCFO. The HHS/OCFO commented that the proposed standard requiring an end-of-period reporting date adds unnecessary financial reporting burden and audit expense, with little additional precision, given the very long-term nature of these liabilities.

Although not objecting to the valuation date standard in general, the DoD Office of the Actuary believes that a provision of the proposed standard impinges on the DoD Retirement Board of Actuaries’ independence in the final determination of valuation assumptions. They noted that the “best estimate” paragraph (paragraph 30) requires the entity’s own assumptions to be consistent with “generally accepted assumptions as evidenced by independent sources, for example, those used by the Federal Bureau of Economic Analysis for the National Income and Product Accounts. If its assumptions did not reflect such

data, the entity should adjust its assumptions to incorporate information from independent sources, or explain why it is inappropriate to do so.” They believe this negatively affects the DoD Retirement Board of Actuaries’ independence in setting long-term economic assumptions for the valuation of the Military Retirement System.

### ***Other Issues***

#### **Scope**

The SSA/OCFO recommends that the proposed statement explicitly exclude Social Security and SSA's Statement of Social Insurance (SOSI) from its scope. They recommend that the statement state explicitly that the preparation and display of the SOSI follows the standards promulgated in SFFASs 17, 25 and 26.

The SSA/OCFO representatives also expressed concern regarding the impact of any future standard that changed the liability recognition point for Social Security and thereby made this discount rate standard applicable to it.

If at some point in the future FASAB changes the recognition point of the OASDI liability beyond due and payable, items included in current FASAB standards as well as emerging FASAB standards, which would then impact the new OASDI liability, should receive independent consideration from the FASAB as they relate to the OASDI program. For example, if this draft standard is approved, it would require the use of a standardized discount rate. ... If at some point after the passage of this standard, a new standard changing the liability recognition point for OASDI were to become effective, SSA would have to change its discounting methodology to conform since currently no other FASAB standard addresses the discount rate used for OASDI. I'm sure there are probably many other examples where these types of implementation issues would need to be addressed by FASAB to ensure its standards do not have the unintended consequence of changing the actuarial methodology of developing the OASDI Trustees Report or SSA's SOSI.

## ***II. FASAB Staff Changes in the Proposed Standard in Response to Agency Comments Received***

### ***Display Standard***

Responding to comments from the actuary who is consulting with the VA and others, staff has added a provision to the display standard. For instances where it is impractical in the preparer's judgment (e.g., too costly vs. the benefit) to distinguish between the two components of actuarial gains and losses, i.e., between (1) experience vs. assumptions and (2) changes in assumptions, the standard now provides that the preparer may, under those circumstances, combine these two items on the SNC and in the footnote disclosure into one discretely presented line item. [See paragraphs 22 in the ED at Tab F-1. The display standard was contained in paragraphs 17-22 in the January draft and now are contained in paragraphs 19-25.]

Responding to a suggestion regarding the display standard from the actuary who is consulting with VA and others, staff added a note disclosure whereby the entity would disclose market rates for long-term Treasury securities. [See *paragraphs 23 in the ED at Tab F-1.*] On the other hand, the DoD Office of the Actuary questioned the value of this disclosure, although they did not have major objections to it. They commented that the discount rate assumption, by necessity, is based on judgmental expectations for average rates over the course of the projection underlying the actuarial calculations and does not have to equal or have any particular relationship to current market rates for long-term Treasury securities. The staff recommends this disclosure as a useful benchmark against which to compare the entity's discount rate, and recommends exposing this provision for comment. The staff has added a question for respondents regarding this disclosure. [See *Question for Respondents #3.*]

Regarding HHS/OCFO's objection to the new line item on the SNC, staff did not change the proposed display standard. The line item is a primary element of the proposal. With respect to different modes of communication, there has been consensus among members that the large cost variations attributable to changes in assumptions must be explained. A necessary first step in explaining these effects is to segregate the amounts attributable to the change. The most visible way to segregate the amounts is on the face of the statement.

<b>Does the Board agree with the above changes to the display standard?</b>
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### ***Discount Rate Standard***

Regarding the discount rate standard, the staff recommends the following changes to the proposed statement. [See *the ED at Tab F-1, paragraph 26. The discount rate standard was contained in paragraphs 23-25 in the January draft and now are contained in paragraphs 26-27.*]

First, the standard has been changed so that the discount rate can be either multiple rates associated with each future year in which cash outflows occur, as proposed in January, or a single average rate, as preferred by the OPM and DoD actuaries. Staff believes that the former is the better concept, as evidenced in current accounting and actuarial literature. It reflects more precisely the time value of money for each future year. However, in the Federal context a single average rate will have limited influence on current liability estimates because yield curve on long-term, average Treasury rates would be relatively flat. In addition, the proposal is for a weighted average rate, with weights assigned based on annual cash outflows. Thus, there would be a relationship between the discount rate and the future years of payment.

With respect to a single average discount rate, some may favor a simple average instead of a weighted average. We have added a question for respondents on the issue of a simple average rate versus a weighted average. [See *the ED at Tab F-1, Question 7.*]

The staff has also eliminated the requirement for separate discount rates for service cost and interest cost on the obligation that were contained in paragraphs 24 and 25 of the January draft. This approach did not lend itself to the single average rate alternative.

Responding to other actuarial comments, the standard explicitly states that the discount rate does not have to change every year, although it does not preclude the preparer from doing so. This would allow actuaries to keep the discount rate constant for multiple years as long as the historical long-term average rate is not materially affected. [See the ED at Tab F-1, paragraph 27.]

In addition, the staff initiated a relatively minor change. The standard now requires the preparer to incorporate in the assumed discount rate expected reinvestment rates extrapolated from the existing Treasury yield curve when future cash flows extend beyond the maturities for which Treasury securities are available, e.g., beyond the 30-year security. The staff became aware of this possible source of uncertainty from the comments from actuarial personnel. [See the ED at Tab F-1, paragraph 26.]

<b>Does the Board agree with the changes to the discount rate standard?</b>
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### ***Valuation Date Standard***

Regarding the valuation date standard, the two primary Federal agencies for employee pensions and other retirement benefits, OPM and DoD, did not object to it since they are currently rolling forward their measurements pursuant to an existing FASAB standard. Although HHS commented that they think it adds unnecessary financial reporting burden and audit expense, the staff believes greater weight should be given to the OPM and DoD responses with respect to this issue because any additional burden would fall primary on them. In addition, staff believes such roll forwards result in a more accurate estimate.

### ***Other issues –***

#### ***Scope***

Responding to the SSA/OCFO, the staff has added a paragraph to the scope section to explicitly exempt social insurance programs for which SFFAS 17 and other statements provide standards. [See the ED at Tab F-1, paragraph 17.] In the event that future standards affect the accounting for social insurance, changes can be made at that time.

Regarding the scope of the statement in general, the staff concludes that the Board views the scope paragraph (paragraph 3 in the January ED) as adequate, with two changes.

First, the words “recognized in accordance with the provisions of SFFAS 5” should be deleted. This will clarify that the standard is not limited to SFFAS 5 liabilities but rather applies generally to long-range liabilities.

Second, the words “and discounted present value” should be deleted from the last sentence of the paragraph. This will clarify that the use of discounted present value is not a criterion for applying the standard.

The basis for conclusions explains that (1) long-range estimates on which the Board is focusing frequently employ discounted present value; and (2) the entity is required to display the effect of changes in long-range assumptions even if discounted present value is not employed. (*See the ED at Tab F-1, paragraph A2.*)

In addition, the scope paragraphs have been moved from the introductory section to the body of the standard. [*See paragraphs 14-18 in the ED at Tab F-1.*]

<b>Does the Board agree with the changes to the scope paragraphs?</b>
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***Materiality***

The DoD Office of the actuary favored the materiality paragraph because it allows the preparer to exercise judgment regarding which gains and losses from changes in assumptions to display. This is the materiality paragraph. [*See the ED at Tab F-1, paragraph 21.*] No other comments were received on this paragraph.

Staff believes that paragraph 21 in the ED at Tab F-1 provides useful guidance and reflects the approach in a recent FASAB standard. Staff recommends exposing it for comment.

<b>Does the Board agree with the materiality paragraph?</b>
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***III. Staff's Summary of the Board's Decisions Having General Application***

The January minutes for this project provide the staff's summary of the Board's decisions in January having a general application as follows:

1. The display standard will be general but list examples of the known programs.
2. Explore the concepts of controllable and non-controllable assumptions and operating and non-operating costs to distinguish the type of assumptions reported below the line.
3. Address the Department of Veterans' Affairs (VA) volatility problem without changing other actuarial practices.
4. The standard should avoid requiring the discount rate to change every year.
5. A decision on the necessity of a materiality paragraph is pending staff research for the March meeting.
6. The scope paragraph (paragraph 3) in the ED captures the Board's intent, at least tentatively, with two changes. First, delete the words “recognized in

- accordance with the provisions of SFFAS 5,” and delete the words “and discounted present value” from the last sentence of the paragraph.
7. More information is needed on the “best estimate” issue.”

The following paragraphs discuss these items.

### **A General Standard with Examples**

Regarding the Board’s decision that the display standard will be general and include examples of the known programs, the staff recommends that the standard include, at a minimum, the following programs as examples of programs to which it applies:

- a. Pensions, ORB, OPEB, including especially VA benefits;
- b. Environmental clean-up;
- c. Guarantees, excluding loan guarantees, e.g., pension guarantees;
- d. Insurance; and
- e. Contingent liabilities for which the confirming event is 5 years or more in the future.

The list of examples immediately above is included in the draft ED at Tab F-1, paragraph 14. Staff believes that these constitute the liabilities of interest to the members, at a minimum. Estimates for these liabilities involve long-term assumptions. These liabilities are included in the *Analytical Perspectives*, Chart 13-1, “The Financial Condition of the Federal Government and the Nation,” and on the FY 2006 FR balance sheet.

Regarding insurance liabilities, insurance accounting in both FASAB and Financial Accounting Standards Board (FASB) standards is predicated on the distinction between short- and long-duration contracts. For both short- and long-duration insurance contracts a liability would be accrued for unpaid claim costs when insured events occur, including claims incurred but not reported (IBNR). Accounting for long-duration contracts also requires that a liability be recognized for future policy benefits. The liability represents the present value of future benefits to be paid to or on behalf of policyholders, less the present value of net future premiums. The liability for future benefits is an estimate based on assumptions used at the inception of the contract about, for example, expected investment yields, mortality, morbidity, terminations, and, of course, the discount rate. In addition, a liability for “premium deficiency” is required using revised assumptions. The FY 2006 Financial Report of the United States Government (FR) reports \$72.8 billion of insurance liabilities.

Regarding contingent liabilities, the staff concludes that the members favor a fixed time-period so that assumptions with short-term effect will not be included, and staff is proposing 5 years. [See ED at Tab F-1, paragraph 15.]

<b>Does the Board agree with this approach?</b>
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### ***“Controllable” and “Non-controllable” Assumption Changes***

At the January meeting, the Board discussed whether the notion of “controllable” and “non-controllable” changes in assumption could be a criterion for selecting gains and losses to display separately on the SNC.

The proposed statement does not reference this notion. Staff concludes that, given the difficulty in definitively defining “control” with respect to changes in assumptions, pursuing this distinction would not be productive.

However, the staff believes that several features help to clarify the standard. First, the standard emphasizes the distinction between short- and long-term assumptions and defines “long-term” as five years or more. [See the ED at Tab F-1, paragraph 15.] Second, the proposed standard is general but will list specific examples of liabilities. Staff recommends a list of programs. Third, illustrations are included. Fourth, the staff recommends that the standard specify that assumptions for contingences must be at least 5 years in duration.

Part of the rationale for reporting gains and losses from changes in assumptions is the principle that when aggregate reporting is misleading – and therefore, the corollary, when disaggregate reporting would illuminate important aspects of the entity or program – disaggregation is appropriate.

In SFFAC 2, the Board noted that identifying management costs separately from program costs enables the use of resources for these activities to be justified on their own merit.

The costs for managing the organization and/or program can ... be displayed on the face of the financial statements or in accompanying footnotes, particularly when it would assist in evaluating operating performance and is cost-effective. Disclosure of what the support costs entail would be appropriate.<sup>2</sup>

In SFFAS 18,<sup>3</sup> the Board addressed controllability of economic factors and other events that would affect default rates. The Board had noted in the ED leading to SFFAS 18 that the magnitude of an interest rate re-estimate is beyond agencies’ control. A respondent to that ED pointed out that some default factors, such as changes in economic conditions and natural disasters are beyond the control of credit programs. The FASAB responded in the final SFFAS 18 as follows:

While it was stated in the March 1999 ED that “the assumed rate is determined by the Administration and is beyond the control of the agency,” that statement does not imply that credit programs can control changes in economic conditions or all of the other events that would impact default rates. However, the Board believes that a reliable assessment of the economic changes and other risk factors in making default subsidy reestimates, whether or not controllable by the agency,

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<sup>2</sup> SFFAC 2, par. 95.

<sup>3</sup> *Amendments to Accounting Standards for Loans and Loan Guarantees (Amends 2)*, May 2000.

can help credit programs better manage program costs and performance. [SFFAS 18, par. 15]

In the Consolidated Glossary FASAB defines “controllable cost” as “A cost that can be influenced by the action of the responsible manager. The term always refers to a specified manager since all costs are controllable by someone.” This definition derives from the cost accounting standard, SFFAS 4.

Thus, the Board has shown a primary interest in information useful in managing program costs and performance whether or not controllable by the agency. In SFFAS 18, the Board considered changes in assumptions initiated by the Administration as well as economic events non-controllable changes; but, whether controllable or not, both were to be assessed.

<b>Does the Board agree that the standard is sufficiently specific, including the examples?</b>
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### ***Best Estimate***

Regarding the issue of “best estimates,” staff requested assistance from the HHS and the CMS several times. The HHS/OCFO and CMS are aware of the issue and of the staff’s request for a statement of the issues that they encountered during the last audit. They have welcomed the Board’s effort to address an issue that was troublesome for them during the last audit cycle. They have indicated a willingness to assist and even expressed an interest in expediting the process. However, as of this date, staff has not received input from them on this issue. Staff will continue to seek their assistance.

In order to proceed on this issue, the staff believes that the Actuarial Standards of Practice (ASOP) may be a source of guidance. Paragraph 30 of the ED at Tab F-1 currently provides a standard with respect to “best estimates” that is similar to the ASOP 10.<sup>4</sup>

With respect to paragraph 30, the DoD Actuarial Office suggested deleting the phrase in paragraph 30 that directs the preparer to compare its assumptions with independent sources and to conform if necessary. They stated that this would require the DoD Retirement Board of Actuaries to incorporate non-specified “independent sources” and impinge on the independence of that Board in setting the long-term economic assumptions for the valuation of the Military Retirement System.

The staff believes that comparing an entity’s assumptions with assumptions in use at Federal statistical agencies such as the Bureau of Economic Analysis constitutes check of reasonableness. It would enhance the process and highlight any assumptions out of

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<sup>4</sup> ASOP 10, *Methods and Assumptions for Use in Life Insurance Company Financial Statements Prepared in Accordance with GAAP*, Revised Edition, Developed by a Task Force of the Life Committee of the Actuarial Standards Board, Adopted by the Actuarial Standards Board March 2000.

step with those generally in use in the Federal Government. On the other hand, the staff has added the phrase “or explain why it is inappropriate to do so” at the conclusion of paragraph 30, which would mitigate any negative effect on preparers.

The staff has also changed a phrase in paragraph 30 about which some FASAB members expressed concern at the January meeting. The phrase essentially defined “best estimate” as the most likely “amount in a range of possible estimated amounts.” This phrase was derived from SFAC 7. However, the staff has replaced that phrase with “outcome of events;” thus, the sentence now reads “best estimate is the most likely outcome of events.” This phrase reflects wording in ASOP 10, focuses on the entity’s judgment about possible future events, and removes the uncertainty regarding what “ranges of possible amounts” would mean in practice.

<b>Does the Board agree with the “best estimate” provisions?</b>
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***Specific Changes in the Exposure Draft and Staff-initiated Edits***

The January minutes for the project list, in the “conclusions” section, the specific changes in the exposure draft (ED) that the members favored and staff-initiated edits, in addition to the staff’s view of the Board’s decisions having a general application. These changes and edits are as follows:

Specific Changes in the ED Directed by Members

1. Delete the words “and discounted present value” from paragraph 3.
2. Delete the reference to “liabilities in SFFAS 5” in paragraph 3.
3. Delete the word “major” from paragraph 17 and anywhere else it may appear in this context in the ED.
4. Delete the word “qualitative” from paragraph 19, the materiality paragraph.
5. Delete references to the role of the social insurance discussion from the ED.
6. Move the contents of the scope paragraph, ED paragraph 3, from the introduction section to the body of the standard.
7. Add a question for respondents regarding the list of short-term or otherwise explicitly exempted assumptions in paragraph 18.
8. Add an explanatory sentence to paragraph 1A to make is parallel subsequent paragraphs.
9. Replace the explanatory paragraph in the executive summary with the essence of paragraph A6 as a better expression of the purpose of the display standard.
10. Add a definition of “short-term” and “long-term” for the Board’s consideration, possibly based on number of years.
11. Develop the footnote disclosure for the FR.

### Staff Initiated Edits

1. For the Board's consideration, change "service cost" to "annual cost increment" were appropriate because "service cost" does not capture all annual incremental cost. The phrase "service cost" is used in pensions, other retirement benefits, and other situations where service is provided in exchange for a deferred benefit, but does not always express incremental cost clearly in other programs.
2. Add a question for respondents regarding the definition of "best estimate" in paragraph 27.
3. Add paragraphs explaining the effect on prior standards.
4. Change the dates in the ED to reflect the project new schedule.